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# Moving Money: International Financial Flows, Taxes, and Money Laundering

By RICHARD GORDON AND ANDREW P. MORRISS\*\*

Money “moves” internationally through electrons and physically among financial institutions and non-financial institutions as part of global trade in legitimate goods and services and as part of legitimate transnational capital investment, and, regrettably, as part of criminal enterprise. Some analysts argue that the movement of a large amount of these funds<sup>1</sup> through offshore financial centers (OFCs) suggests a problem with the financial system that puts “global financial capital . . . beyond the control of any one national government, able effectively to cast judgment on the fiscal and monetary policies of nation states themselves through the disciplinary fear of capital flight.”<sup>2</sup> Many of these analyses purport to distinguish between “onshore” transactions that are “fully regulated and taxed” and “offshore” transactions “where

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1. See, e.g., Mark P. Hampton & Jason P. Abbott, *The Rise (and Fall?) of Offshore Finance in the Global Economy: Editors' Introduction*, in OFFSHORE FINANCE CENTERS AND TAX HAVENS: THE RISE OF GLOBAL CAPITAL (Mark P. Hampton & Jason P. Abbott, eds., 1999) (noting claim that “as much as half the world’s stock of money either resides in or is flowing through tax havens”).

2. *Id.* at 2; see also KERN ALEXANDER ET AL., GLOBAL GOVERNANCE OF FINANCIAL SYSTEMS: THE INTERNATIONAL REGULATION OF SYSTEMIC RISK 67 (2006) (asserting that OFCs “pose a major regulatory concern because they often lack adequate regulation and present numerous obstacles to customer identification”).

some regulations and taxation are withheld.”<sup>3</sup> Most recently, the Tax Justice Network caught public attention by arguing that, “[a] significant fraction of global private financial wealth . . . has been invested virtually tax-free *through* the world’s still-expanding black hole of more than 80 ‘offshore’ secrecy jurisdictions”<sup>4</sup> though they also ranked the United States in the top five in terms of financial secrecy.<sup>5</sup> Similarly, the popular press often portrays “offshore” transactions as sources of criminal activity. To illustrate, following the revelation that Jean-Jaques Augier, the former campaign treasurer for President Hollande held bank accounts in the Cayman Islands, the French newspaper *Le Monde* printed a front page editorial entitled “The offshore system, this patent enemy of democracy.” The piece attacked “fiscal paradises,” generally interpreted as offshore centers, as a source for money laundering.<sup>6</sup>

Much of the discussion of international financial transactions revolves around arguments about “unfair competition” and “distortions” introduced into financial and legal arrangements by jurisdictions with tax structures that differ from developed world norms. For example, offshore critic Ronen Palan argues that what sets offshore finance apart is that “it drives economic activities into jurisdictions they should not have been in the first place.”<sup>7</sup> As a

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3. Ronen Palan, *Offshore and the Structural Enablement of Sovereignty* in OFFSHORE FINANCE CENTERS AND TAX HAVENS: THE RISE OF GLOBAL CAPITAL 18, 21 (Mark Hampton & Jason Abbott, eds., 1999).

4. James S. Henry, *The Price of Offshore Revisited: New Estimates for “Missing” Global Private Wealth, Income, Inequality, and Lost Taxes* 5, TAX JUSTICE NETWORK (July 2012), available at [http://www.taxjustice.net/cms/upload/pdf/Price\\_of\\_Offshore\\_Revisited\\_120722.pdf](http://www.taxjustice.net/cms/upload/pdf/Price_of_Offshore_Revisited_120722.pdf).

5. *Financial Secrecy Index, 2011 Results* TAX JUSTICE NETWORK <http://www.financialsecrecyindex.com/2011results.html> (last visited Oct. 29, 2013). See also ROBERT KEATS, A CANADIAN’S BEST TAX HAVEN: THE US 7 (2012) (arguing that “The US meets virtually all the requirements of a good tax haven for Canadians.”).

6. Editorial, *Le système offshore, cet ennemi patenté de la démocratie*, LE MONDE, Apr. 4, 2013, at 1 (translation by the authors).

7. Palan, *supra* note 3, at 35. Places that economic activities “should not” be include the Cayman Islands, about which Palan says “[s]trictly speaking, it does not make economic sense for the Cayman Islands to serve as the world’s fifth largest financial centre.” *Id.* Thus, Palan argues:

[I]t does not make sense for the Marshall Islands, Vanuatu or Liberia to be the world’s giant shipping nations. There is no obvious economic reason why small Pacific islands are at the forefront of the telecommunications revolution, nor why Guyana and Niue are the central routing areas for Internet porn. In direct contradiction to the theory of comparative

result, critics contend that the existence of these jurisdictions “distort[s] the relocation policies of international capital.”<sup>8</sup>

These arguments rest on a profound misunderstanding of how financial transactions occur.<sup>9</sup> We argue below that much of this “tax justice” literature is driven by its incorrect assumptions about money, business, finance, and government. The assumptions are disguised by often overheated rhetoric and pseudoscientific, or completely unscientific calculations. Like a three card monte dealer rapidly shifting cards on a box while distracting his victims with rapid chatter, some proponents of “tax justice” divert debates over tax policy, global finance, and international business away from the economic underpinnings of financial transactions and the fundamental substantive policy differences that should be the focus of discussion. Although they seek to persuade policymakers that adopting their proposed policies will not limit the beneficial aspects of the existing financial system, what they are advocating is a

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advantage which assumes that economic activities tend to gravitate towards geographically relevant areas, offshore has the opposite effect.

*Id.* In a similar vein, another critic, Sol Picciotto, argues that “[b]y providing a haven for routing global flows through the use of artificial persons and transactions, ‘offshore’ has helped to dislocate the international state system and induce its substantial reconstruction.” Sol Picciotto, *Offshore: The State as Legal Fiction*, in OFFSHORE FINANCE CENTRES AND TAX HAVENS: THE RISE OF GLOBAL CAPITAL, *supra* note 1, at 43, 43. To some extent, all taxes have such impacts. Corporate taxes “cause capital to flow to unincorporated productive sector” and “distort investment and financing decisions, and may discourage the distribution of dividends.” Emilio Albi, *The challenges of corporate income taxes in a globalized world*, in THE ELGAR GUIDE TO TAX SYSTEMS 131, 162 (Emilio Albi & Jorge Martinez-Vasquez, eds., 2011).

8. Palan, *supra* note 3, at 35. Palan’s analysis ignores a key element of such jurisdictions’ appeal to businesses: their legal and regulatory systems. *See, e.g.*, Tony Freyer & Andrew P. Morriss, *Creating Cayman as an Offshore Financial Center: Structure and Strategy Since 1960*, ARIZ. ST. L.J. (forthcoming 2014); Andrew P. Morriss, *The Role of Offshore Financial Centers in Regulatory Competition*, in OFFSHORE FINANCIAL CENTERS AND REGULATORY COMPETITION (Andrew P. Morriss, ed., 2010). To ignore comparative advantage in providing a legal and regulatory environment is a significant error in analysis. *See* ERIN A. O’HARA & LARRY E. RIBSTEIN, *THE LAW MARKET* (2009).

9. They are often made by “repentant sinners,” such as former employees of consulting firms engaged in global finance who purport to offer an insider’s knowledge of how greedy individuals deprive their governments of their share of those individuals’ incomes. *See, e.g.*, Henry, *supra* note 4; JAMES S. HENRY, *THE BLOOD BANKERS: TALES FROM THE GLOBAL UNDERGROUND ECONOMY* (2005); JOHN PERKINS, *CONFESSIONS OF AN ECONOMIC HIT MAN* (2005). As far as we can tell from their writings, none of these repentant sinners has offered to make reparations for their own shares of the ill-gotten gains they claim their former employers secured.

fundamental reordering of global finance in ways that we contend would reduce social welfare.

We believe that a continuum exists as to how those who formulate public policy view international money movements. At one end are those who believe that such movements are illegitimate unless subject to strict public control. At the other end are those who believe that such movements are the legitimate workings of the market and need no public controls. Most probably have a view somewhere in between these extremes—that while most international money movements consist of legitimate market activities, some public controls are needed to prevent abuse. The real question is: where along the continuum is the best public policy choice, and based on what criteria?

We believe that much current commentary (and actual public policy) is hewing too close to the “illegitimate without strict control” end. We refer to this as the “control first” view. “Control first” advocates often begin by neglecting the benefits of free markets, and then overstate the benefits of control while ignoring the costs of those controls.

We, on the other hand, believe that one should begin with the view that voluntary transactions among people and firms that wish to trade and invest with one another is a positive good, and therefore that keeping transactions costs of “moving” money from one place to another is also a positive good. We also believe that some public controls are needed to prevent the costs of abuse, and that any controls must be judged by their costs to market efficiency and their real, demonstrated benefits. At no time should policy makers assume that controls have no costs, or that because controls are well intentioned they have good results. Because we believe in including both benefits and costs of free markets, market abuse, and controls of market abuse, we call this the “Efficient Enterprises” view. To be clear, we are not anti-regulation; we are against inefficient and wasteful regulation.

Those of us that hold this view believe that we should start by looking at the benefits of international markets in goods and services, which cannot take place without the international movement of money. For example, the Peterson Institute for International Economics calculates that Americans alone benefitted

from trade liberalization by nearly \$1.4 trillion in 2012.<sup>10</sup> It is not just rich countries that benefit. By the 1970s, "[e]conomic growth in the open world market economy ha[d] been so great that few governments are now in strong enough control over their civil societies to be able to deny them the chance to participate in this wealth-creating system."<sup>11</sup> In 1998, the head of the World Trade Organization (WTO) cited the growth in trade as a cause of the doubling of income in ten developing countries with a combined population of 1.5 billion and overall annual growth in the world economy of 1.9% per year since World War II, a historically high figure.<sup>12</sup> This was the dominant vision in international private law until the 1990s and underlies how international financial institutions were constructed.

On the other hand, "Control First" begins by seeing the "movement" of money as a problem unless subject to control. Control can only be implemented if information on the money has been reported to governments (or occasionally quasi-governmental organizations), which will then be able to use the information to prevent transactions that represent the proceeds of crime, including the evasion (and, increasingly, the legal avoidance) of taxes. In this vision, transfers of money, international finance, and globalization are seen first as the means by which the powerful exploit others, depriving the victims of their livelihoods and resources. For example, the Tax Justice Network argues in its widely cited report *The Price of Offshore Revisited* that \$21 trillion to \$32 trillion in "financial" wealth in 2010 was "hidden" in OFCs and so is "virtually tax free."<sup>13</sup> Similarly, analyst Raymond Baker contended

10. , *Economy & Trade*, OFFICE OF THE U.S. TRADE REPRESENTATIVE <http://www.ustr.gov/trade-topics/economy-trade> (last visited Oct. 29, 2013).

11. See JOHN STOPFORD, SUSAN STRANGE & JOHN S. HENLEY, RIVAL STATES, RIVAL FIRMS: COMPETITION FOR WORLD MARKET SHARES 55 (1991). Note that, as Stopford et al. argue, this does not mean that governments must adopt laissez faire policies, but rather that governments have different options and different effective powers in an open economy world than they did when autarky was a more realistic option. *Id.*

12. Press Release, WTO News, Renato Ruggiero, *From vision to reality: the multilateral trading system at fifty*, (Mar. 4, 1998), available at [http://www.wto.org/english/news\\_e/pr98\\_e/pr94\\_e.htm](http://www.wto.org/english/news_e/pr98_e/pr94_e.htm).

13. Henry, *supra* note 4, at 5. The difference between \$21 trillion and \$32 trillion is substantial – with the upper bound over 50% higher than the lower bound – but TJN's argument is essentially that the amount is large, regardless of the precise figure.) The report has been frequently cited in news accounts. See, e.g., Heather Stewart, *£13bn hoard hidden from taxman by global elite*, GUARDIAN (July 21, 2012), <http://www.theguardian.com/business/2012/jul/21/global-elite-tax-offshore->

in the early 2000s that \$1 trillion in "dirty money" crosses borders annually, and that there was \$5 trillion in accumulated hidden assets (as of the early 2000s).<sup>14</sup> Proponents of the Control First framework argue that the most important impact of financial openness is to allow the looting of developing country economies by a coalition of local elites, multinational businesses, and multinational financial institutions.<sup>15</sup>

The disagreement between these frameworks is partly philosophical. Regardless of the size of "undertaxed" money flows, who gets the money, or benefits of financial freedom, one might believe that taxing every dollar of wealth trumps any benefit. One might believe that a poorer but more equal world is preferable to a richer but less equal one, or, alternatively, that ensuring that investors are free to shift assets wherever they prefer is worth any reduction in tax revenues anywhere, or that eradicating absolute poverty trumps concerns over inequality. The Tax Justice Network, for example, rarely concedes that there is any benefit to the movement of money in the international financial system.<sup>16</sup> As its name suggests, it is focused on applying its definition of "justice" to the tax system, largely to the exclusion of any benefits of financial freedom. However, the disagreement is also empirical - there are important disagreements about the facts: does making international financial flows cheaper help or hurt the global economy, particular economies, or particular individuals?

The relative influence of these visions over future measures governing the international financial architecture in particular countries, in treaties among countries, and in multilateral governance structures will profoundly shape the future of the world economy. In part, the choice between them reflects a disagreement about the mix of different kinds of transactions in the world economy. For example, the more criminal transactions that occur, the greater is the

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economy.

14. RAYMOND W. BAKER, CAPITALISM'S ACHILLES HEEL: DIRTY MONEY AND HOW TO RENEW THE FREE-MARKET SYSTEM 165, 191, 237-38, 258 (2005).

15. See, e.g., HENRY, BLOOD BANKERS, *supra* note 9, at xxiv ("the conventional portrait of the global development crisis is an economist's fairy tale. It leaves out all of the blood and guts of what really happened-all the payoffs, corrupt privatizations, fraudulent loans, intentionally wasteful projects, black market 'round trip' transfers, arms deals, insider information, and the behind-the-scenes operation of the global haven banking network that facilitated this behavior.").

16. Henry, *supra* note 4, at 25.

justification to implement preventive measures. At the same time, however, Control First measures necessarily add transactions costs, which by definition will reduce legitimate, value-maximizing transactions, while perhaps blocking some criminal ones. How to balance the costs and benefits of such measures will depend in part on views about the relative importance of reducing crime, including fiscal crime, (as well as the effectiveness of these measures in actually reducing crime) and of increasing the volume of private, wealth-maximizing transactions. That, in turn, rests not only on disagreements within and across societies over the appropriate size and scope of governments, but also over the costs and effectiveness of different financial infrastructures.

As the global financial crisis provided the opportunity for substantial changes in the world's financial infrastructure, understanding this clash of visions is important. In this Article, we make several contributions. In Part I, we contrast the Efficient Enterprises and Control First frameworks, examining their different assumptions about how the world economy functions. In Part II, we set out the financial "plumbing" through which money "moves" and show why this infrastructure is important and how it affects the two frameworks' policy prescriptions. In Part III, we analyze the evidence provided by the Tax Justice Network, among the primary proponents of the more extreme Control First framework measures, and show that it fails to support their claims. Part IV concludes by setting out some criteria for evaluating policy trade-offs in decisions about financial architectures.

## **I. Alternative Frameworks for International Finance**

Before we can discuss international financial flows and the regulatory frameworks that can be used to shape them, we need to understand what it is that financial transactions do. Not surprisingly, views differ about why money "moves" across borders and the impacts of its movements. Moreover, the Control First attack on "offshore" jurisdictions makes it important to consider the role of these jurisdictions in the global economy and to recognize that these "offshore" locations do not exist in isolation.<sup>17</sup> Their interconnectedness with the rest of the global financial network

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17. Even an OFC critic like Ronan Palan "'offshore' financial transactions are very much 'onshore', conceived, organized and handled in the traditional financial centers of London, New York, Tokyo, and so on." Palan, *supra* note 3, at 21.



makes it necessary to understand how they function—how money “moves” through them—to evaluate these competing visions. Having a clear view of the alternative conceptual frameworks is necessary to understand the legal and policy choices international capital flows present.

### A. *Efficient Enterprises*

The standard economic view of global capital flows is that reducing the obstacles to the flow of money across borders maximizes total global welfare by shifting resources from less efficient to more efficient uses.<sup>18</sup> Crucially, firms are willing to engage in international operations only when the “greater complexity and risk” involved in creating and maintaining “costly systems of command and control that can work effectively over large distances and deal with the hazards of markets that differ from their own” if they believe the gains outweigh these costs.<sup>19</sup> This view sees virtues flowing from the movement of financial resources of individuals and firms across borders, allowing them to reduce concentration risk by engaging in portfolio diversification. It also permits investors to avoid or hedge against risks due to poor quality regulatory frameworks or other causes.<sup>20</sup>

This view can be summarized as follows: obstacles to financial flows constitute transactions costs. In pursuit of wealth maximization, the transactions costs of financial flows should be reduced and financial innovations that promote lower transactions costs should be welcomed.<sup>21</sup> Increasing financial flows creates a range of benefits, from generally facilitating trade and investment, to specifically allowing both the reduction of overall risk and the

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18. For example, Peter Cohen and U. Srinivasa Rangan argue that capital's movement toward higher returns creates pressure to upgrade countries' “Entrepreneurial Ecosystems,” which involves “enhancing corporate transparency, stream-lining capital markets, and building more globally competitive human capital networks.” PETER COHEN & U. SRINIVASA RANGAN, *CAPITAL RISING: HOW CAPITAL FLOWS ARE CHANGING BUSINESS SYSTEMS ALL OVER THE WORLD* 4 (2010).

19. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 69.

20. See, e.g., Michael E. Porter & Martin R. Kramer, *Creating Shared Value*, HARV. BUS. REV. 76 (January / February 2011) (“the ways in which regulations are designed and implemented determine whether they benefit society or work against it.”).

21. This includes regulatory measures that promote “the efficient pricing of capital and financial products” as this helps control systemic risk. ALEXANDER ET AL., *supra* note 2, at 77.

efficient allocation of remaining risks among voluntary parties. The more these are reduced or eliminated, the more efficiently resources are allocated. As resources move about the world, states compete for resources by providing attractive environments for labor and capital in pursuit of wealth-creating activities that can then fund the provision of public goods.<sup>22</sup> Since “a successful capitalist economy depends not only on a successful capitalist class, but also on that class’s willingness to use and invest their money in the domestic economy,”<sup>23</sup> this exerts pressure on states to adopt policies that attract resources, and so generate wealth. Among those policies are limits on tax rates.<sup>24</sup>

In this view, regulatory measures should primarily aim at facilitating markets, not obstructing transactions in pursuit of other policies. This view is embedded in modern international financial institutions such as the International Monetary Fund (IMF), and later, the World Trade Organization (WTO).<sup>25</sup> Promoting it has been an important part of the work of the Organization for Economic Cooperation and Development (OECD).<sup>26</sup> It is also embedded in the European Union’s financial architecture, which emphasizes the free movement of capital,<sup>27</sup> and the creation of the euro.<sup>28</sup> Indeed, so

22. See STOPFORD, STRANGE & HENLEY, *supra* note 11, at 209 (“Without wealth or the prospect of future sources of wealth, even if there is no external security threat, the state begins to fall apart.”); MORRISS, *Role*, *supra* note 8, at 105–109.

23. SVEN STEINMO, *TAXATION & DEMOCRACY: SWEDISH, BRITISH, AND AMERICAN APPROACHES TO FINANCING THE MODERN STATE* 158 (1993).

24. Albi, *supra* note 7, at 142 (low tax jurisdictions “have established limits and lowered CIT [corporate income tax] rates.”). Research into distortions caused by high rates may also push rates down. See Richard M. Bird, *Tax system change and the impact of tax research*, in ELGAR GUIDE, *supra* note 7, at 413, 430 (“The downward pressure on personal and corporate income tax rates has certainly been supported, if not initiated, by the increasing research measuring the distortions caused by high marginal tax rates.”).

25. RAWI ABDELAL, *CAPITAL RULES: THE CONSTRUCTION OF GLOBAL FINANCE* 7 (2007) (“Policymakers then wrote the [liberal] consensus into the institutional architecture of the international monetary system. The rules were codified in three international organizations: the IMF, the European Community (EC), and the OECD.”).

26. Andrew P. Morriss & Lotta Moberg, *Cartelizing Taxes: Understanding the OECD’s Campaign Against “Harmful Tax Competition”*, 4 COLUM. J. TAX L. 1, 21–22, 27–32, 2012) (describing and explaining transformation of OECD tax program). Since the 1990s, however, the OECD’s efforts on tax harmonization (but not its work in other areas) have switched to a Control First perspective. See *id.* at 39–48. ABDELAL, *supra* note 25, at 7.

27. See *id.* at 3 (“European policymakers conceived and promoted the liberal

pervasive is this view that one can reject it only by rejecting the intellectual framework underlying the post-World War II system of international trade law and finance adopted by virtually every nation. This is not to say that problems like corruption should be ignored. Rather, an Efficient Enterprises approach sees increasing financial openness as reducing such problems, not increasing them.<sup>29</sup>

The Efficient Enterprises framework has four central implications for international financial flows. First, financial flows are a *necessary* component of facilitating trade. One can argue—as antiglobalization activists do—against efforts to lower barriers to trade, but if one accepts that comparative advantage makes trade welfare increasing for both parties, one must also accept the virtue of reducing the transactions costs of trade. Second, global financial flows reduce the costs of jurisdictional arbitrage, encouraging jurisdictions to compete for wealth-creating activity by reducing transactions costs. Third, globalized finance inevitably allows tax planning to occur, which reduces the transactions costs of doing business across borders as well as limits tax revenue. Fourth, globalized finance provides financial privacy, which is a good in its own right as well as a means to encouraging additional wealth creation.

### 1. Facilitating Trade

One important reason why Efficient Enterprises proponents favor removing obstacles to financial flows is to facilitate trade. Increased financial flows facilitate trade in important ways.<sup>30</sup> Even

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rules that compose the international financial architecture. The most liberal rules in international finance are those of the EU, and the United States was irrelevant to their construction.”).

28. See DAVID MARSH, *THE EURO: THE POLITICS OF THE NEW GLOBAL CURRENCY* 10 (“the liberalism of an integrated European financial market is one of the essential conditions within the Euro area required to provide the economic flexibility and financial lubrication to offset the rigidity of permanently fixed exchange rates.”).

29. Johann Graf Lambsdorff, *Causes and consequences of corruption: What do we know from a cross-section of countries*, in *INTERNATIONAL HANDBOOK ON THE ECONOMICS OF CORRUPTION* 3, 8-9 (Susan Rose-Ackerman ed., 2006) (summarizing evidence that increased openness is correlated with reduced corruption). Note that political openness may be less effective than financial openness, since corruption can subvert political selection methods. *Id.* at 12-13. Further, firms may be able to adapt to corruption through business structures. *Id.* at 30.

30. The relationship between financial integration and trade can be seen in historical patterns of trade. Just before World War I, financial integration in the

in relatively simple exchanges of cash and goods, financial flows facilitate trade by allowing trading parties to shift activities to the location with the comparative advantage in each activity. Reducing the costs of even simple transactions is important. For example, London owes its historical position as a financial and insurance center to the lower cost of handling trade conducted in sterling there;<sup>31</sup> Hong Kong's entrepôt activities led to the development of its role as an Asian financial center;<sup>32</sup> and New York City developed its role as a financial center out of its role as a domestic capital market

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developed world's economies was quite high. Moritz Schularick & Thomas M. Steger, *Financial Integration, Investment, and Economic Growth: Evidence from Two Eras of Financial Globalization*, (CESifo Working Paper No. 1691) (rev.) (2007) at 4 available at [http://www.jfki.fu-berlin.de/faculty/economics/team/Ehemalige\\_Mitarbeiter\\_innen](http://www.jfki.fu-berlin.de/faculty/economics/team/Ehemalige_Mitarbeiter_innen/schularick/Financial_Integration_Investment_and_Economic_Growth_.pdf?1376087674)

/schularick/Financial\_Integration\_Investment\_and\_Economic\_Growth\_.pdf?1376087674 ("The degree of international financial integration reached before 1914 was truly impressive."). A number of firms managed "their overseas assets as part of an integrated unit rather than as passive investments in a portfolio." STOPFORD, STRANGE & HENLEY, *supra* note 11, at 13 (noting that Colt began such operations in Britain in 1852). The war disrupted the financial integration and the belligerents raised barriers to trade; these persisted after the war ended and trade volume did not recover until recently. By the end of the twentieth century, cross-border financial flows had returned to their pre-World War I level as transactions costs and regulatory barriers fell. *Id.* From 1980 to the early 1990s, cross-border financial transactions in industrial economies grew from less than 10% of GDP to more than 100%. HENRI L. BEENHAKKER, *THE GLOBAL ECONOMY AND INTERNATIONAL FINANCING* 50 (2001). See also STOPFORD, STRANGE & HENLEY, *supra* note 11, at 41 ("Instead of a series of national financial systems linked by a few operators buying and selling credit across the exchanges, we now have a global system, in which national markets, physically separate, function as if they were all in the same place.").

31. Ranald Michie, *A Financial Phoenix: The City of London in the Twentieth Century*, LONDON AND PARIS AS INTERNATIONAL FINANCIAL CENTRES IN THE TWENTIETH CENTURY 15, 17 (Youssef Cassis & Eric Bussiere eds., 2005) (London was "the payments center of the world economy, for through these connections it was possible to settle almost any international transaction there. Hence the fact that the 'bill on London' was the near universal currency of international trade and finance, whether it involved transactions between China and the United States or France and Australia.").

32. Catherine R. Schenk, *The Rise of Hong Kong and Tokyo as International Financial Centres after 1950*, in CENTRES AND PERIPHERIES IN BANKING: THE HISTORICAL DEVELOPMENT OF FINANCIAL MARKETS 2, 6 (Philip L. Cottrell et al. eds., 2007) ("Hong Kong's role as a regional and international financial center arose from the strong commercial heritage of banking and financial services, which continued to dominate activity in the colony throughout the 1950s and 1960s, and positioned Hong Kong as the regional center for the exchange of information and expertise on Asian and Western market opportunities. In this sense, Hong Kong clearly fits into the model of an IFC emerging from an international commercial entrepot.").

for the United States.<sup>33</sup>

The competitive advantage of a multinational firm will depend on where it locates its activities (either the activities it does directly or those it contracts for in the marketplace).<sup>34</sup> Structuring a multinational business involves more than one-off exchanges of goods and services for cash, it also requires more complex transactions that reduce the transactions costs of cross-border activity. Among the important risks for cross-border investments are principal-agent conflicts. Building longer term relationships can reduce principal-agent conflicts and so reduce the risks involved in cross-border transactions.<sup>35</sup> Similarly, sophisticated financial arrangements enable parties to reduce the costs of transacting by allocating or hedging risks (e.g., currency risk) among the parties.<sup>36</sup>

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33. YOUSSEF CASSIS, *CAPITALS OF CAPITAL: A HISTORY OF INTERNATIONAL FINANCIAL CENTRES 1780-2005* 115 (2006) (New York's importance due to "three reasons: the total amount of foreign capital investment in the United States, the dynamism of the American economy, and the city's position as the country's financial centre" in period before World War I.).

34. MICHAEL E. PORTER, *THE COMPETITIVE ADVANTAGE OF NATIONS* 60 (1998) ("Over time, however, successful global firms usually combine advantages drawn from their home base with those resulting from locating particular activities in other nations and those emerging from the overall world-wide network.... The combination of home base advantages, the benefits of locating selected activities in foreign locations, and advantages growing out of the worldwide system, not each alone, underpins international success."); BEENHAKKER, *supra* note 30, at 31 ("If the global competitor locates its different activities in different countries according to each country's comparative advantage, it will then, at the same time, achieve competitive advantage. For instance, components can be made in South Korea, software written in India and basic R&D performed in Silicon Valley.").

35. For example, accounting serves as a crucial means of facilitating cross-border investment. Indeed, the development of the accounting profession in the United States is at least partly due to the need to persuade European (and particularly British) investors to invest in American railroads. See PAUL J. MIRANTI, JR., *ACCOUNTANCY COMES OF AGE: THE DEVELOPMENT OF AN AMERICAN PROFESSION, 1886-1940* 34 (1990) ("The certificate of a well-known accounting firm was thought to improve the marketability of American securities among European investors."); THOMAS A. KING, *MORE THAN A NUMBERS GAME: A BRIEF HISTORY OF ACCOUNTING* 14-17 (2006) (describing issues involved in railroad and other securities); GEOFFREY P. MILLER & FABRIZIO CAFAGGI, *THE GOVERNANCE AND REGULATION OF INTERNATIONAL FINANCE* 142 (2013) ("Accounting is about reducing information asymmetry. The rise of trans-national companies and cross-border investments exposed the deficiency of the old local accounting framework to deal with these transactions, and the world is today moving towards a more globalized accounting practice, with regulations trying to follow.").

36. See, e.g., Björn Döhring, *Hedging and invoicing strategies to reduce exchange rate exposure: a euro-area perspective* 1 (EU Econ. & Fin. Affairs Directorate, Econ. Papers No. 299, 2008), available at [http://ec.europa.eu/economy\\_finance/publicatio](http://ec.europa.eu/economy_finance/publicatio)

Making such arrangements requires both financial service providers (e.g., banks, accountants, insurance companies, lawyers) and well-developed legal and regulatory systems. Because these are often not available or too costly in some jurisdictions, structuring transactions through jurisdictions where such services are available or are less expensive facilitates trade.<sup>37</sup>

Consider a relatively simple trade arrangement between a manufacturer in one country and a retailer in another. The parties to the trade deal face a number of risks, including currency risks, legal risks, and political risks. For example, a U.S. retailer contracting with a Chinese supplier to send its goods to be sold in the United States would need, at a minimum, to address risks due to differences in the U.S. and Chinese legal systems, currency risks for dollar-renminbi conversions, and political risks that U.S.-China relations could be disrupted in a fashion that would affect the transactions. If the relationship were even slightly more complex, as it would be if the U.S. retailer and Chinese manufacturer wanted to enter into a joint venture that required the U.S. partner to invest in China and transfer intellectual property rights to the joint venture, these risks would be greatly increased. Relationships between a U.S.

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ns/publication11475\_en.pdf ("Exchange rate risk can also be neutralized ("hedged") through financial instruments, such as exchange rate derivatives or foreign currency debt (financial hedges), as well as through the operational setup of the exporting firm (operational hedges). Financial derivatives have today become standard tools for hedging risks related to exchange rates, interest rates or commodities prices."); Ron Box, *Reducing Pricing Risks with Effective Hedge Strategies*, CORPORATE FIN. INSIDER (Feb. 3, 2011), [http://www.cpa2biz.com/Content/media/PRODUCER CON TENT/Newsletters/Articles\\_2011/CorpFin/ReducePricingRisks.jsp](http://www.cpa2biz.com/Content/media/PRODUCER CON TENT/Newsletters/Articles_2011/CorpFin/ReducePricingRisks.jsp) ("Mitigating financial risk with hedge transactions can be very helpful to businesses of all sizes, particularly as those risks become more pronounced. Many circumstances beyond the control of financial executives can affect the commodities critical to business operations or the interest rates required for capital."); GORDON DE BROUWER, *HEDGE FUNDS IN EMERGING MARKETS* 1-2 (2001) (noting usefulness of currency trades to "[a]n exporter who wants to eliminate the risk that the currency will appreciate before he receives his foreign-exchange receipts" and who is able to "sell that foreign exchange now for delivery at some time in the future" which leads to a "process of intermediation ... whereby banks trade the foreign-exchange risk until someone who wants the exposure — typically a speculator — can get it.").

37. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 222 (In many developing countries, legal systems are antiquated, contradictory and impenetrably obscure. Firms need to know the extent of their legal obligations and of their legal rights. Although it is reasonable for a government to reserve the right to change the rules, the changes should be consistent, pointed in the same direction, and transparently clear. Arbitrary decisions provide one of the biggest disincentives to investors.").

firm and a French firm, a Chinese firm and a South African firm, or a British firm and a Chilean firm would face a similar array of risks, although the details of the particular risks might differ. Because any contract defining the rights of the parties would necessarily be incomplete,<sup>38</sup> the parties would need confidence that any future disputes would be resolved fairly and efficiently. One way to provide such confidence is through sophisticated financial transactions. For example, valuable assets of the joint venture might be owned by a legal entity that was bankruptcy-remote from either of the joint ventures. More sophisticated financial instruments promote liquidity and allow better management of risks.<sup>39</sup> Another means of coping with incomplete contracts is to choose the law and legal institutions of a jurisdiction other than the home jurisdictions of the contracting parties (to avoid potential bias).<sup>40</sup>

Currency risks are a simple example of a problem parties face in international trade. Changes in exchange rates, including changes in the value of outstanding financial obligations incurred prior to a change in exchange rates, changes in the present value of firms due to changes in the net present value of future operating cash flows, and accounting-derived changes in owners' equity from the translation of foreign-currency denominated assets and liabilities into the currency in which accounts are reported.<sup>41</sup> The risk of inflation differs dramatically across jurisdictions—and inflation is itself a form of a tax.<sup>42</sup> An important means of managing these risks

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38. See, e.g., Eric Maskin & Jean Tirole, *Unforeseen Contingencies & Incomplete Contracts*, 66 REV. ECON. STUD. 83, 83 (1999) ("Most real contracts are vague or silent on a number of significant matters."); Eric A. Posner, *Economic Analysis of Contract Law After Three Decades: Success or Failure?*, 112 YALE L.J. 829, 833 (2003) ("A theoretically complete contract would describe all the possible contingencies, but transactions costs—including the cost of negotiating and writing down the terms—and foreseeing low-probability events, render all contracts incomplete.").

39. See, e.g., MILLER & CAFAGGI, *supra* note 35, at 43–44 (discussing role of CDS instruments).

40. See, e.g., *The Report on the First Five Years of the Hong Kong Special Administrative Region of the People's Republic of China* 25 (2002), available at [http://www.info.gov.hk/info/sar5/content\\_e.htm](http://www.info.gov.hk/info/sar5/content_e.htm) ("The most important [advantage over the Mainland] is Hong Kong's legal system, which is trusted, tried and tested by international business.").

41. BEENHAKKER, *supra* note 30, at 149.

42. Patrick Honohan, *Avoiding the Pitfalls in Taxing Financial Intermediation*, in TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES 1, 19–20 (2003).

is by hedging currency exposures.<sup>43</sup> Another is through contractual provisions, shifting the risk to the party most willing or able to bear it at the lowest cost.

The foundation for the case for trade is comparative advantage, the idea that productivity differentials across jurisdictions (differences in the cost ratios for producing different goods and services) translate into opportunities for gains from trade.<sup>44</sup> However, global competition does more than just promote trade based on existing comparative advantages, it also spurs innovation. Cohen and Rangan describe how the evolution of the personal computer industry over the last thirty years illustrates this:

Far from being a vertically integrated, few-firms-dominated industry as its predecessor main-frame industry used to be, the new industry has from its beginning been highly decentralized. The splintering of the vertical chain was facilitated by the standardization of various parts, components, operating systems, and microprocessors. In turn, this led to the springing up of a large number of new manufacturers specializing in key parts of the value chain in many parts of the world and especially in Asia, a classic case of global spur to entrepreneurship. . .<sup>45</sup>

As a result, they argue that the growth in international trade was facilitated by a combination of micro developments ("such as advances in product design and process technology") and macro developments ("such as the acceptance of a liberal international trading order").<sup>46</sup>

Trade thus expanded the number of firms and diversified their locations, producing a greater demand for cross-border financial transactions above and beyond the increase that would result from firms diversifying their own operations across borders. The benefits of such expansion go well beyond the immediate benefits from trade: opening economies brings in both new physical technology and knowledge embedded "in the brains of people, in organizational structures and in behavioral patterns, which in turn are conditioned by the strategies of different social factors and their patterns in conflict and co-operation."<sup>47</sup> This growth makes taxation

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43. *Id.* at 149-50.

44. *Id.* at 29.

45. COHEN & RANGAN, *supra* note 18, at 13.

46. *Id.* at 14.

47. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 72 (quoting Ernst &



of capital more difficult, however, since the growth of multinational business deals and organizations combined with "the common propensity of national government[s] to offer tax incentives, deductions, exemptions, credits, and so on" makes it easier to shift income to the lowest tax jurisdiction and avoid or evade taxes.<sup>48</sup>

Finally, expanding trade increases the need for access to deep capital markets and, crucially, to legal systems capable of handling complex business organization and contractual matters. The common practice of raising capital on the New York and London financial markets by non-American and non-British companies, respectively, illustrates this.<sup>49</sup> To accommodate such needs, a legal system needs both a group of sophisticated decision makers and regulators capable of adding value without imposing excessive costs and a body of law that allows transaction engineering to structure transactions to predictably accomplish clients' goals.<sup>50</sup> Financial transactions may thus be structured to take advantage of such jurisdictions by legally locating crucial steps (e.g., issuing bonds) in them (discussed below).

## 2. Facilitating Jurisdictional Arbitrage

While traditional trade theory focuses on differences in factor endowments (e.g., natural resources), skill levels, or costs in the workforce,<sup>51</sup> differences in legal and regulatory regimes also play an important role in structuring cross-border transactions. In particular,

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O'Connor).

48. STEINMO, *supra* note 23, at 29. U.S. taxation of capital income relative to earned income is particularly heavy relative to most other nations. *Id.* at 36.

49. See Ethiopis Tafara & Robert J. Peterson, *A Blueprint for Cross-Border Access to U.S. Investors: A New International Framework*, 48 HARV. INT'L L.J. 31, 34 (2007) (describing growth of foreign investor use of NYSE stock exchanges); Darius P. Miller & John Puthenpurackal, *The Costs, Wealth Effects, and Determinants of International Capital Raising: Evidence from Public Yankee Bonds* (Apr. 2001), available at [http://www.bus.umich.edu/jfi/WDI\\_Miller.pdf](http://www.bus.umich.edu/jfi/WDI_Miller.pdf) (describing use of U.S. bond markets by foreign firms). See also Richard Benzie, *The Development of the International Bond Market*, (BIS Econ. Papers, No. 32, Jan. 1992), available at <http://www.bis.org/publ/econ32.pdf> (describing growth of international bond market in 1980s); Juan Carlos Gozzi et al., *How Firms Use Domestic and International Corporate Bond Markets* (NBER Working Paper No. 17763, Jan. 2012).

50. DAVID HOWARTH, LAW AS ENGINEERING: THINKING ABOUT WHAT LAWYERS DO 3 (2013) ("Clients come to lawyers, as they come to engineers, with problems that they cannot solve themselves. The service both engineers and lawyers provide is the solving of those problems.").

51. BEENHAKKER, *supra* note 30, at 29.

jurisdictions may compete to provide services, regulatory regimes, or dispute resolution services that facilitate business across borders.<sup>52</sup> Businesses make use of these differences across jurisdictions; within jurisdictions, policy entrepreneurs respond to such opportunities by pursuing strategies to provide services in the marketplace. Erin O'Hara and Larry Ribstein describe how this market for law functions within the U.S. federal system; the same process encourages competition among jurisdictions internationally.<sup>53</sup> This is particularly important in finance, where innovation is centered on "the creation of new instruments by repackaging the cash flows generated by others."<sup>54</sup>

The Netherlands Antilles developed a significant business after World War II in facilitating U.S. businesses issuing bonds in the Eurocurrency market as the result of a combination of a fortuitous extension of the U.S.-Netherlands tax treaty to non-European Dutch territories, the growth of a huge pool of dollars outside the United States, and an entrepreneurial notary's efforts.<sup>55</sup> Similarly, the Cayman Islands created a legal framework for company formation, banking, trusts, and insurance through the collaborative efforts of local political leaders, lawyers and other professionals, and British officials.<sup>56</sup> Guernsey and Jersey developed financial services businesses through their proximity to the City of London financial district, the high costs of post-World War II British exchange control regulations for multinational businesses, and their jurisdictional distinctiveness relative to the United Kingdom, which includes laws making it easier and less expensive to form companies than in the United Kingdom as well as low or no taxation of income.<sup>57</sup> Once the legal and regulatory environments are recognized as factors of

52. See O'HARA & RIBSTEIN, *supra* note 8.

53. Morriss, *Role*, *supra* note 8, at 112-117. See also STOPFORD, STRANGE & HENLEY, *supra* note 11, at 1 ("states are now competing more for the means to create wealth within their territory than for power over more territory. . . . [While] the emergence of new forms of global competition among firms also affects how states compete for wealth.")

54. Honohan, *supra* note 42, at 18.

55. See Craig M. Boise & Andrew P. Morriss, *Change, Dependency, and Regime Flexibility in Offshore Financial Intermediation: The Creation, Collapse, and Return of Curacao and the Netherlands Antilles*, 45 TX. INT'L L.J. 377, 404-410 (2009).

56. Freyer & Morriss, *supra* note 8, at 21-24.

57. R.A. JOHNS & C.M. LE MARCHANT, *FINANCE CENTRES: BRITISH ISLE OFFSHORE DEVELOPMENT SINCE 1979* 18, 55 (1993) (discussing advantages of location near London and U.K. exchange controls, and distinctive jurisdictional status).

production, developing a sophisticated regulatory environment conducive to financial transactions becomes a development strategy.

In particular, a jurisdiction's legal and regulatory environment may provide it with a significant comparative advantage because of the quality of its legal system. For example, courts in the Hong Kong SAR, Delaware, and Britain are all widely recognized as capable of addressing sophisticated business transactions competently and fairly.<sup>58</sup> Jurisdictions whose legal systems have ties to the United Kingdom similarly have an advantage in this regard because of the availability of appeals to the Privy Council.<sup>59</sup> Because many legal systems recognize choice of law and choice of forum clauses in business agreements, parties to international business transactions can exploit the comparative advantage of a jurisdiction in law by electing to have a contract governed by, and disputes addressed in, that jurisdiction.<sup>60</sup> The existence of jurisdictions that specialize in providing legal and regulatory systems that efficiently structure transactions is thus not a mystery to be explained but the logical outcome of a system of relatively free trade, legal systems' enforcement of choice of law and choice of forum provisions, and the operation of comparative advantage. As demand for legal and regulatory services to support a global economy grows, the opportunity for jurisdictions to earn revenue by providing those services increase as well. The wider market for such services, including for specialized products like protected cell companies and international investment funds, also

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58. See, e.g. *International businesses to be encouraged to use British courts for economic growth*, DAILY RECORD (Mar. 14, 2013), <http://www.dailyrecord.co.uk/news/uk-world-news/international-businesses-encouraged-use-british-1764194> (U.K. Justice Secretary touting "unrivalled reputation" of U.K. courts in business cases); Donald F. Parsons, Jr. & Joseph R. Slight III, *The History of Delaware's Business Courts*, BUSINESS LAW TODAY (Mar./Apr. 2008) available at <http://apps.americanbar.org/buslaw/blt/2008-03-04/slights.shtml> (discussing Delaware Chancery Court's worldwide reputation for fairness, experience, and expertise in presiding over corporate disputes."); *Hong Kong has best judicial system in Asia: business survey*, AFP (Sept. 18, 2008), [http://www.google.com/hostednews/afp/article/ALeqM5gIkKvk-YnNQ1HVB2n\\_HUUMhncDLA](http://www.google.com/hostednews/afp/article/ALeqM5gIkKvk-YnNQ1HVB2n_HUUMhncDLA) (reporting survey of business executives finding Hong Kong rated best).

59. See Stefan Voight et al., *Improving Credibility by Delegating Judicial Competence – The Case of the Judicial Committee of the Privy Council*, (December 2004) available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=652682](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=652682) (discussing enhancement of credibility from using Privy Council as final court of appeal).

60. O'HARA & RIBSTEIN, *supra* note 8, at 6–7.

offers opportunities for jurisdictions to compete for niche products.<sup>61</sup>

Within the United States, Delaware is the leader in providing business organizations' law and dispute resolution, with a well-regarded statutory framework, court system, and network of service providers.<sup>62</sup> Delaware entered the market for corporate law as the U.S. economy grew and transitioned from a primarily agricultural and extractive industries-based economy into a diversified manufacturing economy.<sup>63</sup> It won the business away from New Jersey by offering a better product and has maintained its competitive edge by continually innovating and offering the best corporate law court system in the United States.<sup>64</sup> Similarly, Vermont is widely recognized as a jurisdiction with laws and regulators that facilitate captive insurance.<sup>65</sup> Internationally, jurisdictions such as Bermuda, the Cayman Islands, the British Virgin Islands, Guernsey, Hong Kong, Ireland, and Jersey all compete for business by offering a combination of cost-efficient regulatory frameworks that facilitate particular businesses, low or neutral direct taxation regimes, and high quality courts.<sup>66</sup> In exactly the same way, New York City and London compete for international business by offering access to well-organized, deep capital markets with legal frameworks and agglomerations of

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61. See Paul Scrivener & Thomas M. Jones, *Incorporated Cells: The latest development for Cayman Islands segregated portfolio insurers*, CAYMAN FIN. REV. (July 12, 2013), <http://www.compasscayman.com/cfr/2013/07/12/Incorporated-cells/> (discussing introduction of new legislation to enhance market appeal of Cayman entities); Freyer & Morriss, *supra* note 8, at 33–37 (discussing efforts to compete for additional markets).

62. Parsons & Slight, *supra* note 58. See also Brian Broughman, Jesse M. Fried, & Darian Ibrahim, *Delaware Law as Lingua Franca: Evidence from VC-Backed Startups* (Working Paper, 2012), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2117967](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2117967) (arguing Delaware has advantage because investors understand its law).

63. Charles M. Yablon, *The Historical Race: Competition for Corporate Charters and the Rise and Decline of New Jersey: 1880-1910*, J. Corp. L. 323, 379 (2007) (annual incorporations rose from 421 in 1899 to 1,325 in 1910). See also, Roberta Romano, *Competition for Corporate Charters and the Lesson of Takeover Statutes*, 61 FORDHAM L. REV. 843, 845 (1993) (by 1920, Delaware was the leading state for incorporation).

64. Parsons & Slight, *supra* note 58.

65. *Vermont Captive Insurance Leader Discusses Emerging Areas, Challenges*, INSURANCE JOURNAL (Sept. 26, 2012), <http://www.insurancejournal.com/news/east/2012/09/26/264495.htm>.

66. Even critics of OFCs like Ronen Palan concede that “[o]ffshore offers many benefits and it is doubtful whether the modern international economy can function as smoothly as it does without it.” Palan, *supra* note 3, at 26.

service providers that protect investors and facilitate financial transactions.<sup>67</sup> The rapid rate of financial innovation in the major financial markets after World War II has also tended to shift transactions to those jurisdictions that compete for the business most aggressively.

In addition to the benefits this competition provides directly to parties structuring international business transactions, this competition pushes other jurisdictions to innovate as well. Just as Delaware competes for corporate charters in the United States, and London and New York compete for financial services business internationally, jurisdictions also compete for specific slices of the financial business, and that spurs quality improvements even in large jurisdictions. Thus Vermont created onshore captive insurance legislation to compete for business with Bermuda and the Cayman Islands,<sup>68</sup> and the United States created International Banking Facilities to compete with offshore centers.<sup>69</sup>

Moreover, this competition offers a significant advantage to individuals and firms outside the major, developed economies. Entrenched interests in governments may make it difficult to change policies within poorer economies: "When change will create too many local 'losers,' it will be resisted no matter how strong are the rational arguments."<sup>70</sup> It levels the playing field between firms and individuals in jurisdictions with advantageous legal systems and those in jurisdictions that are not by allowing the latter to opt into a higher quality legal system. For example, such competition allows

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67. See CASSIS, *supra* note 33, at 263–68 (describing advantages of New York and London).

68. Lindsay Kelly, *Perception drives more captives to form onshore*, THE ROYAL GAZETTE ONLINE, (Apr. 18, 2012), <http://www.royalgazette.com/article/20120418/BUSINESS04/704189968> (quoting Vermont insurance commissioner that "We're not the first onshore domicile but we really pursued it and made a success out of it," he said. "Because Vermont is a very small state with 600,000 people with a tourist-based economy, it meshed really well for us."). See also Morriss, *supra* note 8, at 136–138.

69. Palan, *supra* note 3, at 33 (at end of 1970s "as the result of a prolonged and complicated battle between the US Treasury, the Swiss government and a number of Caribbean tax havens. With the active encouragement of the New York banking community, particularly Citibank and Chase, the US Treasury came to the conclusion that rather than fight the onset of offshore, the USA stood to gain by encouraging its own offshore center .... A swift volte-face took place, culminating in the establishment of the New York offshore market, the New York International Banking Facilities (IBF), on 1 December 1980.").

70. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 30.

firms from outside the developed world to tap into First World capital markets and other institutions. As a result, “[i]n nascent or growing industries like nanotechnology or biopharmaceuticals, firms from countries like India and China are now competing intensely because they are able to tap into the global entrepreneurial ecosystem through capital access,” with the result that they are making “the lives of managers and owners of firms in many industries less comfortable.”<sup>71</sup> This is because “[t]he availability of capital” has allowed firms from India to “acquire companies in other advanced countries by tapping into the global capital market.”<sup>72</sup>

### 3. Tax Planning

In the Efficient Enterprises framework, tax planning is a rational response to tax laws. Indeed, it is the only response possible for an individual or firm faced with the need to comply with the conflicting provisions, definitions, and exemptions of multiple jurisdictions’ tax laws.<sup>73</sup> Under the Efficient Enterprises framework, tax law is conceptualized as a multi-period interaction in which governments create tax statutes and regulations, taxpayers react by reorganizing their affairs to reduce their net payments of taxes (taking into account the costs of tax planning services), governments respond by changing tax laws to limit opportunities to make such reorganizations, and taxpayers respond. As Patrick Honohan notes, financial sector tax design “is confounded by arbitrage between functionally equivalent contracts or institutional forms” and requires attention to the relative elasticities of financial market activities.<sup>74</sup> However, it is important to keep in mind that financial innovations are not necessarily tax driven.<sup>75</sup>

71. COHEN & RANGAN, *supra* note 18, at 23.

72. *Id.*

73. See, e.g., Robin Boadway, *Individual income taxation: income, consumption, or dual?*, in ELGAR GUIDE, *supra* note 7, at 93, 117 (treating different sources of income differently virtually required by various considerations but creates system “that invites tax planning opportunities and perhaps even tax evasion.”); Albi, *supra* note 7, at 131 (“In an international system, the CIT induces tax competition among governments and income shifting between nations in the search for lower tax liabilities by multinational firms. Compliance and enforcement costs, or avoidance and anti-avoidance schemes, consume real resources and lead to reduced welfare.”).

74. Honohan, *supra* note 42, at 17.

75. Robin Boadway & Michael Keen, *Theoretical Perspectives on the Taxation of Capital Income and Financial Services*, in TAXATION OF FINANCIAL INTERMEDIATION:

The growing internationalization of economic activity makes this more of a challenge for governments by limiting their ability to collect corporate taxes.<sup>76</sup> Through multiple cycles of such efforts, governments strike a balance between tax revenue collection, tax complexity, and the other policies that might be served by tax law provisions (e.g., inducing investment). Such a balance need not be reached by increasing severity of enforcement or tightening regulations: in response to the liberalization of capital flows in the EU in the 1980s, many countries eliminated wealth taxes.<sup>77</sup>

Both taxpayers and tax authorities must strike such balances. The result is complexity, which, as Albi notes, "is the rule in tax systems, steering discussions toward less distortionary and costly solutions, within the established constraints, as opposed to more perfect, albeit impracticable, alternatives."<sup>78</sup> Developing countries in particular may lack the resources to develop tax policies to address financial innovations.<sup>79</sup> Even among OECD countries, rules often differ on sophisticated transactions.<sup>80</sup> Changes in levels of tax avoidance and tax evasion can be partially explained by changes in tax systems. For example, as even some OFC critics concede, tax planning's growth is undoubtedly due, at least in part, to the shift away from indirect taxation to direct taxation over the twentieth century.<sup>81</sup> (There is also evidence that direct taxation is more

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THEORY AND PRACTICE FOR EMERGING ECONOMIES 31, 53 (2003) ("The massive financial innovation of recent years has been driven much more by commercial considerations—especially the better management of risk—than by the avoidance of tax.").

76. STEVEN A. BANK, *FROM SWORD TO SHIELD: THE TRANSFORMATION OF THE CORPORATE INCOME TAX, 1861 TO PRESENT* xi (2010) ("the advent of the multinational corporation has surely placed competitive pressure on the structure of the purely domestic corporate tax system.").

77. Mattias Levin & Peer Ritter, *Taxation of Financial Intermediation in Industrial Countries*, in *TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES* 197, 220 (2003).

78. Albi, *supra* note 7, at 130. See also STEINMO, *supra* note 23, at 38 ("All countries complicate their tax systems with equity considerations and through the use of tax structures as instruments of economic and social policy. But no country is nearly as detailed as the United States in its attempts to adjust tax burdens."); *Id.* at 161 (noting that "every [U.S.] tax reform has been presented as a simplification of the tax system, but each has in fact complicated the tax system.").

79. Boadway & Keen, *supra* note 75, at 55.

80. *Id.*

81. Picciotto, *supra* note 7, at 48.

vulnerable to corruption than indirect taxation.)<sup>82</sup> Together with rising rates, this increases the incentive to avoid and evade taxes. It is thus an endogenous response to tax provisions, including but not limited to rates.

Moreover, despite critics' attempts to blur the lines, tax avoidance is conceptually distinct from tax evasion: avoidance is minimizing taxes within the rules of the law, while evasion is breaking the law by not paying taxes due under the law.<sup>83</sup> This approach is well summarized by the response of a member of the band U2 to a journalist's inquiry about the band's relocation of its music publishing business to the Netherlands after a change in Irish tax law that would have led to higher taxes on the band's royalties: The Edge (David Evans) stated, "Of course we're trying to be tax-efficient. Who doesn't want to be tax-efficient?"<sup>84</sup> Who indeed? As one guide to tax planning argued, Warren Buffett was able to pay an average tax rate of just 11 percent on 2010 income of \$69 million by taking "the majority of his income in the form of dividends, tax-free municipal bond interest, and capital gains."<sup>85</sup>

Moreover, trying to be tax-efficient by moving a company from one jurisdiction to another is conceptually no different from a firm issuing debt rather than equity to take advantage of the deductibility of interest,<sup>86</sup> an individual buying a house rather than

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82. Lamsdorff, *supra* note 29, at 37.

83. One way to lump avoidance and evasion together does not necessarily favor those critical of avoidance. As Steinmo describes the evolution of U.S. tax code, as the Congressional system became more open during the 1970s, the result "made an already porous system even more loophole-ridden." STEINMO, *supra* note 23, at 141. The result was "disastrous." *Id.* at 142. "Tax expenditures" as a percentage of income tax receipts grew from 40.7 percent in 1973 to 103 percent in 1986. Thus avoidance required securing a favor from a member of Congress to create a "loophole" in the tax code; evasion skipped the step of securing favors (and so presumably the cost of the campaign contributions necessary to secure the cooperation of the member) at the risk of possible prosecution if the evasion was discovered. Does the legitimacy of a provision depend on whether or not its existence was legally or illegally purchased from the legislature or executive? How would one tell? If others illegally purchase loopholes, is evasion of the greater burden created for the taxpayer who is unsuccessful at doing so illegitimate?

84. Timothy Noah, *Bono, Tax Avoider*, SLATE (Oct. 31, 2006), [http://www.slate.com/articles/news\\_and\\_politics/chatterbox/2006/10/bono\\_tax\\_avoider.html](http://www.slate.com/articles/news_and_politics/chatterbox/2006/10/bono_tax_avoider.html). The move reportedly cut the band's tax bill on its royalties by half. *Id.*

85. KEATS, *supra* note 5, at 102.

86. John R. Graham, *How Big Are the Tax Benefits of Debt?*, 60 J. FINANCE 1901 (2000) (discussing tax benefits of debt over equity); Deen Kemsley & Doron Nissim, *Valuation of the Debt Tax Shield*, 57 J. FINANCE 2045 (2002) (finding debt shield



renting to take advantage of the mortgage interest deduction,<sup>87</sup> an investor buying a tax-exempt public bond instead of a taxable private one,<sup>88</sup> or a firm with unused nonrefundable tax credits choosing to merge with a firm with net income that would allow the use of the credits.<sup>89</sup> Stephen Bank terms the expanded use of pass-through entities (LLCs, limited partnerships, S corporations, and similar entities) likely “the most significant factor” in the decline in corporate tax revenue in the United States.<sup>90</sup> It is impossible to find a principled conceptual difference between changing a business from a C-corporation to an LLC within the United States and changing it from a U.S. based corporation to a Bermuda based one.<sup>91</sup> Sijbren Cnossen argues that, “in reality, most interest is not taxed at all [in Europe] due to the symbiosis between interest deductibility at company (and personal) level and the existence of capital-rich tax-exempt investors, such as pension funds, life insurance companies

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significant despite personal tax implications); BANK, *supra* note 76, at xiv (noting that the U.S. Treasury estimates that “equity is taxed at an effective rate that is approximately 40 percent, debt has a negative tax burden of minus 2 percent.”); Boadway & Keen, *supra* note 75, at 53–54 (“The tax preference for debt over equity ... has long figured centrally in the analysis of corporate financial decisions.”). *But see* Albi, *supra* note 7, at 161 (noting that innovations in finance are “making it increasingly difficult to distinguish between debt and equity instruments”).

87. The Center for Budget and Policy Priorities, a left-leaning group sympathetic to expanding federal spending, called the mortgage interest deduction “one of the largest federal tax expenditures” and estimated that it reduced federal tax revenue by \$70 billion per year. Will Fischer & Chye-Ching Huang, *Mortgage Interest Deduction is Ripe for Reform*, Center on Budget and Policy Priorities (June 25, 2013), <http://www.cbpp.org/cms/?fa=view&id=3948>. Moreover, they concluded that “the bulk of its benefits go to higher-income households.” *Id.*

88. STEINMO, *supra* note 23, at 75–76 (noting that when Sixteenth Amendment debated in United States, “[i]t was agreed that interest from state and local bonds, which was becoming an indispensable source of revenue for these governments, should be exempted from the new federal tax. It was understood not only that this would provide an incentive for wealthy individuals to buy these bonds, but also that these same individuals would be able to use the bonds to protect their income from the federal taxation.”).

89. This was the goal of the merger in question in the landmark *Smith v. Van Gorkom* case. 488 A.2d 858 (Del. 1985). *See also* BANK, *supra* note 76, at xxvii–xxviii (noting crucial role of carryforward provisions for newer firms relative to older ones).

90. *Id.* at xviii.

91. Moreover, as Bank notes, business taxation originally focused on corporations rather than partnerships because collecting at the source on dividends was administratively convenient and out of a desire to avoid the “most inquisitorial aspects of the income tax.” *Id.* at 38–39.

and social security funds.”<sup>92</sup>

This approach is reflected in many jurisdictions’ laws. For example, in the United Kingdom and many other Commonwealth countries, following the literal statutory construction of the tax law may be all that is needed to avoid tax, even if the form of the transactions do not reflect the economic substance that was the original object of the law. As explained in the House of Lords’ decision in the 1935 opinion of Lord Tomlin in *IRC v. Duke of Westminster*,

Every man is entitled, if he can, to order his affairs so as that the tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.<sup>93</sup>

In the United States, since the landmark case of *Gregory v. Helvering*, the economic substance of transactions typically triumphs over their form, at least when the clear purpose of the statutory construction is to address the economic substance.<sup>94</sup> However, to quote Judge Learned Hand, in his opinion in the *Gregory* case at the Appeals Court level, even in America “anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes.”<sup>95</sup>

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92. Sijbren Cnossen, *Company Taxes in the European Union: Issues and Options for Reform*, 17 FISCAL STUDIES 67 (1996).

93. *IRC v. Duke of Westminster* (1936) AC 1, 19–20 (U.K.). The Duke reduced his taxes by covenanting to pay some of his employees yearly sums as an annuity, regardless of work done or whether they remained in his service; in practice this substituted for their wages. As the wages were not deductible from the Duke’s income but the annuity payments were, this reduced his tax liability. The circumstances are described in detail in Assaf Likhovski, *Tax Law and Public Opinion: Explaining IRC v Duke of Westminster*, in 2 STUDIES IN THE HISTORY OF TAX LAW 183 (John Tiley, ed., 2007).

94. *Gregory v. Helvering*, 239 U.S. 465 (1935). The taxpayer had followed the technical rules for avoiding a tax on capital gains by selling shares as part of a tax-free corporate reorganization, even though the result was not, in fact, a real “reorganization” of the type the statute was attempting to address. The Court upheld the conclusion of the Bureau of Internal Revenue, which had ruled that the economic substance of the transactions should prevail over the legal form. The substance over form view has been recently reaffirmed by the Supreme Court in *PPL Corp v. Commissioner*, Sup. Ct. Dkt. No. 12-43 (2013).

95. *Helvering v. Gregory*, 69 F.2d at 810–11. Later, Hand extended this view.

In short, under the Efficient Enterprises framework, governments set rules for tax obligations, and individuals and firms then react by structuring their affairs to minimize structuring costs and taxes. If a particular set of tax laws produces too little tax revenue for a government's purposes, the government then responds by altering the tax laws (increasing rates, broadening the base, changing definitions, limiting exemptions, and so forth) to increase its revenues. The problems with such transactions are primarily the result of poor statutory or regulatory drafting rather than bad behavior by firms or individuals (except where they violate the law). Typically, the solution to tax evasion is to focus on structuring taxes to be collected at the source and requiring entities to report payments. But the legislative system for repealing or enacting laws cannot and should not be short-circuited through the exercise of political pressure on selected taxpayers.

#### 4. *Financial Privacy*

Individuals may view privacy as a good to seek in its own right, either because it meets their preferences or because it reduces other costs. Thus, an individual may not want his personal financial affairs known because that is his personal preference, or a firm may wish that rivals not know details of its business strategy. Of course, criminals also seek to conceal their activities. Legal systems regularly seek a balance between privacy interests and law enforcement interests, permitting intrusion into private matters only under limited circumstances.<sup>96</sup> Privacy in financial affairs can thus

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"Over and over again courts have said that there is nothing sinister in so arranging one's affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law demands: taxes are enforced exactions, not voluntary contributions. To demand more in the name of morals is mere cant." *Commissioner v. Newman*, 159 F.2d 848, 850-51 (2d Cir. 1947) (Hand, dissenting).

96. See AMITAI ETZIONI, *THE NEW GOLDEN RULE: COMMUNITY AND MORALITY IN A DEMOCRATIC SOCIETY* 12 (1996) (arguing that steps to limit privacy should only be taken in face of a "well-documented and macroscopic threat to the common good, and not merely a hypothetical danger and that if the threat can be minimized by less intrusive means than invasion of privacy, those means should be adopted instead); Kenneth Einar Himma, *Privacy Versus Security: Why Privacy Isn't an Absolute Right*, 44 *SAN DIEGO L. REV.* 857, 876 (2007) (arguing that the two dimensions to balancing privacy and security are: "(1) the importance of the interest relative to the type of interest involved, and (2) the number of people whose security are implicated compared to the number of people whose interest in privacy are implicated." However, he has little to contribute to the means of weighing these interests.); Fred H. Cate, *The EU Data Protection Directive, Information*

be seen as an outgrowth of the general principle that a person's privacy (including the privacy of an association of persons) should be respected unless there are circumstances that suggest a crime has been committed or there is some other significant social interest at stake.<sup>97</sup>

Financial privacy is not a novel concept: Many jurisdictions' laws recognize this interest. As Rose-Marie Antoine notes,

In my view, confidentiality has been used largely as a scapegoat, blamed for encouraging money laundering and tax evasion. The result of linking it so intimately to such criminal activity has been that confidentiality in the offshore sector has acquired a negative image. On examination of the jurisprudence, however, confidentiality remains a viable and much respected principle in areas of commercial endeavor not associated with offshore investment. For example, the United States and Canada have fought long and hard to protect the principle of financial confidentiality in terms of trade secrets, arguing precisely that it is essential for business.<sup>98</sup>

Indeed, the evolution of the U.S. federal income tax over its first decades reveals a steady progression away from methods that even today would appear abusive to many.<sup>99</sup> Most importantly, confidentiality in financial affairs has long been provided by

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*Privacy, and the Public Interests*, 80 IOWA L. REV. 431 (1994-95) (European Parliament overwhelmingly supported legislation that personal data can only be used for the purpose collected, which can only be processed under consent, or to protect public interests or the legitimate interest of a private party when that interest does not exceed the fundamental rights and freedoms of the data subject.).

97. There are a wide range of reasons why an individual or firm might want information kept confidential which do not involve illegal activities. Professor Rose-Marie Antoine has described these in detail. See ROSE-MARIE ANTOINE, *CONFIDENTIALITY IN OFFSHORE FINANCIAL LAW* 33-38 (2002).

98. Rose Marie Belle Antoine, *The Legitimacy of the Offshore Financial Sector: A Legal Perspective*, in *OFFSHORE FINANCIAL CENTERS AND REGULATORY COMPETITION*, *supra* note 8, at 30, 35.

99. See, e.g., BANK, *supra* note 76, at 44-45. Bank describes how nineteenth century income tax authorities would publish lists of taxpayers and their income in local newspapers, "in the hopes of securing more accurate returns" and would have assessors "complete the taxpayer's return through a series of inquiries into all aspects of the taxpayer's personal and financial affairs," methods which David Wells, the Commissioner of Internal Revenue during the first federal income tax, termed "arbitrary and inquisitorial methods and agencies ... entirely antagonistic to and incompatible with the principles and maintenance of a free government." *Id.* at 45.

attorneys advising their clients and by financial firms handling client money and property. Such confidentiality has been guaranteed by jurisdictions in which those persons work. Financial privacy in the common law world has been well established since at least the 1924 English Court of Appeal decision in *Tournier v. National Provincial and Union Bank of England*.<sup>100</sup> This decision has been called "one of the most respected and celebrated instances of judicial law making in the entire field of banking."<sup>101</sup> The decision "has been approved, applied and reaffirmed by courts in every common law jurisdiction, including Australia, Canada, Hong Kong, Ireland and New Zealand."<sup>102</sup> Based in contract, *Tournier* held a bank liable for disclosing to a customer's employer that the customer had paid a bookmaker by check. In addition to this contractual duty, a number of non-common law jurisdictions have created statutory duties of confidentiality.<sup>103</sup> For example, Swiss law imposes criminal penalties on those who disclose banking information without authorization.<sup>104</sup>

Moreover, the business reasons for privacy make businesses' affairs worthy of protection. For example, firms need data that reflects business plans, trade secrets, or strategic decisions to be kept confidential.<sup>105</sup> Similarly, a law firm's or financial institution's client would not want its plan to purchase a company—a plan likely based on a significant expenditure of resources in research—to be broadcast to others, who could free-ride on that research and rob the client of a legitimate competitive advantage.<sup>106</sup> This is particularly likely to be true in the investment fund business, where fund managers closely guard strategies.<sup>107</sup> Equally obviously, wealthy clients would want to

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100. *Tournier v. National Provincial and Union Bank of England*, (1924) 1 KB 461 (U.K.).

101. 2 George Weaver & Charles Craigie, *THE LAW RELATING TO BANKER AND CUSTOMER IN AUSTRALIA* 2.3400 (2009) (quoted in Chaikin).

102. David Chaikin, *Adapting the Qualifications to the Banker's Common Law Duty of Confidentiality to Fight Transnational Crime*, 33 SYDNEY L. REV. 265, 271 (2011).

103. ANTOINE, *supra* note 97, at 23–33 (describing Swiss statutory model).

104. Swiss Federal Law on Banks and Savings Banks, SR 952.0-47 (1934).

105. See, e.g., David B. Jemison & Sim B. Sitkin, *Corporate Acquisitions: A Process Perspective*, 11 ACADEMY OF MGT. REV. 145, 155 (1986) (discussing role of secrecy in corporate takeovers); Elizabeth A. Rowe, *Striking a Balance: When Should Trade-Secret Law Shield Disclosures to the Government?*, 96 IOWA L. REV. 791 (2010-11) (discussing protection of trade secrets disclosed to regulators).

106. Jemison & Sitkin, *supra* note 105.

107. See Mary Margaret Frank, James M. Poterba, Douglas A. Shackleford & John

hide the size and location of their wealth from criminals. In countries where crimes such as kidnapping for ransom are common, the desire for confidentiality may be greatest.<sup>108</sup> And while concerns about confidentiality of financial information can be alleviated to some extent by restricting access to law enforcement only, it should be noted that in many countries in the developing world (as well as some in the developed world) law enforcement officials may not keep such information to themselves. Mandatory breaching of confidentiality with respect to financial information relating to transactions can significantly raise the costs of those transactions. Malawi's former dictator, Hastings Banda, once declared: "Everything is my business. Everything. The state of education, the state of our economy, the state of our agriculture, the state of our transport, everything is my business," and, "Anything I say is law. Literally law."<sup>109</sup> Certainly confidentiality in financial matters is a necessary protection for anyone living under such a regime.

Of course, confidentiality or privacy of any kind can also hinder enforcement of criminal and tax laws. In such circumstances, and others, disclosure may be appropriate. Indeed, the decision in *Tournier* explicitly recognized that disclosure of otherwise private financial information was appropriate "(a) where disclosure is under compulsion by law; (b) where there is a duty to the public to disclose; (c) where the interests of the bank require disclosure; [and] (d) where the disclosure is made by the express or implied consent of the customer."<sup>110</sup> Thus there is no question that financial privacy is an interest subject to qualification—the tricky question is when

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B. Shoven, *Copycat Funds: Information Disclosure Regulation and the Returns to Active Management in the Mutual Fund Industry*, 47 J.L. & ECON. 515 (Feb. 2004) (disclosure of positions allows other investors to free-ride on investment strategies undertaken by a fund); Russ Wermers, *The Potential Effects of More Frequent Portfolio Disclosure on Mutual Fund Performance*, 7 PERSPECTIVE 1, available at <http://www.icinet.net/pdf/per07-03.pdf> (disclosure can reduce profits for fund managers by allowing speculative investors to front-run, or trade ahead of the fund).

108. See, e.g., Andrew Osborne, *Russian tycoon 'pays ransom' to free kidnapped son*, THE TELEGRAPH (22 April 2011), available at <http://www.telegraph.co.uk/news/worldnews/europe/russia/8468779/Russian-tycoon-pays-ransom-to-free-kidnapped-son.html> (quoting experts that up to 300 children a year are kidnapped in Russia).

109. MARTIN MEREDITH, *THE FATE OF AFRICA: FROM THE HOPES OF FREEDOM TO THE HEART OF DESPAIR* 165 (2005).

110. *Tournier v. National Provincial and Union Bank of England*, (1924) 1 KB 461, 473 (U.K.).

such qualifications occur. How a society balances these competing interests will depend on a variety of factors, including cultural ones.<sup>111</sup> The key is that a balance must exist, even if striking that balance is difficult.

Both because there are such good reasons to avoid exposing confidential information and because reporting clients would reduce those clients' willingness to do business with them, financial firms have an incentive to err on the side of confidentiality. Consequently, reporting requirements are generally enforced by sanctions for failure to report.<sup>112</sup> As a result, financial institutions are forced into weighing the relative costs of effective compliance with the probability that sanctions will be imposed, introducing more uncertainty and costs to compliance.

Resolutions of that question can be arrayed along a spectrum from "no disclosure without specific evidence of wrongdoing" to "automatic exchange of all relevant information about all transactions." Within the Efficient Enterprises framework, because of the increased costs associated with disclosure, we would expect such questions to be resolved more frequently close to the "no disclosure without specific evidence of wrongdoing" end of the spectrum, unless costs could be reasonably contained. Indeed, many jurisdictions concerned with privacy generally tend toward enhancing privacy rights outside of financial matters, and we observe considerable concern among civil libertarians over intrusion into citizens' nonfinancial affairs.<sup>113</sup> With a few exceptions (e.g., the quite

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111. See Michael Littlewood, *Tax Reform in Hong Kong in the 1970s: Sincere Failure or Successful Charade?*, in 1 STUDIES IN THE HISTORY OF TAX LAW 379, 384–85 (John Tiley, ed., 2004) (describing cultural resistance by Chinese community to disclosing information to Hong Kong tax collectors). These same issues have arisen in connection with the disclosures about the U.S. National Security Agency's collection of cell phone data. See Declan McCullagh, *NSA spying flap extends to contents of U.S. phone calls*, CNET (June 15, 2013), [http://news.cnet.com/8301-13578\\_3-57589495-38/nsa-spying-flap-extends-to-contents-of-u.s-phone-calls/](http://news.cnet.com/8301-13578_3-57589495-38/nsa-spying-flap-extends-to-contents-of-u.s-phone-calls/); Josh Levs & Catherine E. Shoichet, *Europe furious, 'shocked' by report of U.S. spying*, CNN.COM (July 1, 2013), <http://www.cnn.com/2013/06/30/world/europe/eu-nsa> (describing European reaction to disclosures).

112. See, e.g., 31 U.S.C. § 5318g (2012).

113. Imagine the uproar if a government suggested automatic exchange of information on whether individuals were HIV positive or if a jurisdiction like Saudi Arabia where homosexual acts are criminal offenses insisted that European and North American governments automatically provide it with information that could reveal sexual acts by Saudi citizens in Europe or North America or the sexual orientation of those countries' citizens applying for Saudi visas.

strong privacy Switzerland traditionally provided for numbered bank accounts), by the end of the 1980s, most jurisdictions had created at least some mechanism for exchange of information where there was evidence of wrongdoing.<sup>114</sup> The degree of financial privacy would thus be the subject of a combination of a rights-based inquiry (to the extent that privacy concerns generally were protectable) and a cost-benefit analysis of specific measures that eliminated contracted-for privacy in particular instances.

Over the past decade, however, initiatives of the Financial Action Task Force (FATF), the Organization for Economic Cooperation and Development (OECD) and the European Union (and of their key member states) have successfully moved international standards to the “automatic exchange of all relevant information about all transactions” end of the spectrum. This movement from “no disclosure without specific evidence of wrongdoing,” as well as its significant accompanying costs, will be discussed below.

### 5. Summary

Viewed through the Efficient Enterprises framework, the key issue with respect to regulating global movement of money is the reduction of transaction costs to facilitate the creation of more wealth. In Stopford et al.’s analogy of governments to gardeners, the main concern is not maintaining a fence to keep out marauders, the priority is husbandry: improving the water supply, enhancing the fertility of the soil, and keeping a proper balance of sun and shade: “Forward-looking gardeners are now learning about becoming good husbandmen rather than effective fence-keepers.”<sup>115</sup>

Jurisdictions that lubricate trade by facilitating international financial transactions play an important role by offering transaction-cost-reducing innovations and services. Examples of this include: a tax treaty network that reduces double taxation, such as Barbados;<sup>116</sup> a high quality business court and arbitration system, as in Hong Kong;<sup>117</sup> efficiently created, inexpensive business entities to serve as

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114. ANTOINE, *supra* note 98, at 38–39; Freyer & Morriss, *supra* note 8, at 48–50.

115. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 210–11.

116. See *Barbados Tax Treaties*, BARBADOS OFFSHORE ADVISOR <http://barbadosoffshoreadvisor.com/barbados-tax-treaties/> (last visited on Oct. 27, 2013) (Barbados’ reputation as “well regulated, offshore jurisdiction” due to its “extensive tax treaty network with other countries” with a focus on transparency.).

117. See Michael J. Burns et al., *British Virgin Islands: Recent Regulatory Reforms in the British Virgin Islands: Regulating Light, Regulating Right*, MONDAQ (Mar. 26, 2013)



asset protection vehicles for persons fearful of government expropriation, as in the British Virgin Islands;<sup>118</sup> flexible business entities like protected cell companies, as in Guernsey;<sup>119</sup> estate planning entities unavailable in neighboring legal systems, such as common-law-based trusts in the Channel Islands (which offer options to Continental clients not available in the clients' own legal systems);<sup>120</sup> legal environments that make it inexpensive to repackage assets, as with the Cayman Islands and asset securitization, where the combination of a knowledgeable regulator, recognized exchange, and experienced service providers facilitates creating packages acceptable to wide markets;<sup>121</sup> industry clusters, as with Bermuda and reinsurance,<sup>122</sup> or creating service agglomerations that serve the many

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<http://www.mondaq.com:80/x/229250/offshore+financial+centres/Recent+Regulatory+Reforms+In+The+British+Virgin+Islands+Regulating+Light+Regulating+Right&login=true> ("The British Virgin Islands' ('BVI') remains the world's leading offshore center for the incorporation of international business companies, with approximately 450,000 active companies currently registered in the Territory."); PRICE WATERHOUSE, *DOING BUSINESS IN BARBADOS* 5 (1994) ("There is a broadly based offshore business industry that includes international business companies, captive insurance companies, offshore banks, foreign sales corporations, shipping companies, and trusts. Tax treaties with Canada and the United States have been important to the development of this industry.").

118. See, e.g., Kun Fan, *The New Arbitration Ordinance in Hong Kong*, 29 J. INT'L ARB. 715, 722 (2012) ("a leading arbitration center in the Asia-Pacific region. With its strong legal infrastructure, abundance of professional expertise, world class arbitration institutions (such as HKIAC), connection with Mainland China, and New York Convention signatory status, Hong Kong is a natural option for dispute settlement in Asia.").

119. See Bedell Cristin, *Cell Companies in Guernsey*, BEDELL GROUP (2010), <http://www.bedellgroup.com/siteFiles/resources/docs/insights/Breifings/Company%20and%20Commercial%20-%20Guernsey%20Briefings/cellcompaniesinguernsey.pdf> (describing entity which Guernsey was first to create in 1997).

120. GORDON DAWES, *LAWS OF GUERNSEY* 137 (2003) (describing court decisions and legislation to enable trust use).

121. See Memorandum from Conyers Dill & Pearman on Securitization in the Cayman Islands, (2013) (on file with the author) (describing advantages of securitization using Cayman entities).

122. See Marianne Burge, *Captives: Bermuda, Colorado, Taxes and Beyond*, reprinted from *Business Insurance* (Apr. 10, 1972) in *FOREIGN TAX HAVENS: CHOOSING THE RIGHT ONE* 141, 145 (Marshall J. Langer & Roy Albert Povell, chairmen) Tax Law and Practice Course Handbook No. 55 (PLI), J4-2482\_(1973) ("Bermuda has the advantage of being able to offer more of the sophisticated business facilities than most island jurisdictions. It has thriving banking and office facilities, communications and hotels, and grants work permits to foreigners. Bermuda has been an insurance center for many years and has legal and technical expertise available. It is very much concerned to maintain its reputation as a business center

needs of different types of businesses.<sup>123</sup> To the extent there are undesirable impacts of these jurisdictions' provisions of such services on other jurisdictions (e.g., by making it more difficult to track proceeds of crime or through impacts on tax collections), these must be weighed against the benefits provided by the increased financial activity and resolved through international negotiations.<sup>124</sup>

### ***B. Control First***

Like Efficient Enterprises proponents, Control First framework proponents believe that globalization unleashes competitive forces that constrain governments.<sup>125</sup> However, unlike Efficient Enterprises proponents, Control First proponents find this problematic. Rather than increasing welfare, they see these trends as the means for powerful groups to extract resources from less powerful groups. For example, James Henry argues, "the First World has bled the Third, of the financial and human capital that it desperately needs for growth."<sup>126</sup> Similarly, Steven Hiatt argues that developing nations were "lured by economic hit men . . . to take on debt to build grandiose projects . . . [while] large sums flooding in could be useful in winning the allegiance of new Third World elites, who were under pressure to deliver prosperity to their political followers, allies, and extended families."<sup>127</sup> Thus they see globalization primarily as an expansion of the arena in which bad actors can

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for reputable enterprises and screens applicants for local incorporation carefully.")

123. See Michael E. Porter, *Location, Competition, and Economic Development: Local Clusters in a Global Economy*, 14 *ECON. DEV. Q.* 15 (2000) (discussing key role of clusters across industries).

124. For example, the Cayman Islands signed a Mutual Legal Assistance Treaty (MLAT) with the United States in 1986, providing a mechanism by which the United States could request information from the Cayman government about specific individuals and transactions the United States could demonstrate were involved in criminal activities. Freyer & Morriss, *supra* note 8, at 42.

125. Both may be overestimating the impact. Levin and Ritter conclude that the continued existence of capital taxation may indicate that "[t]ax competition is not as strong as is usually thought." Levin & Ritter, *supra* note 77, at 234.

126. HENRY, *BLOOD BANKERS*, *supra* note 9, at 182. Henry argues that this is a literal phenomenon, pointing to purchases of blood plasma from developing countries, which he claims has led to massive HIV infections. *Id.* However, he ignores the parallel blood scandals in France (which he cites for its ban on blood sales). See Mark Hunter, *Blood Money*, *DISCOVER* (Aug. 1993), [http://discovermagazine.com/1993/aug/bloodmoney250#.UW89c7\\_0tdQ](http://discovermagazine.com/1993/aug/bloodmoney250#.UW89c7_0tdQ).

127. Steven Hiatt, *Global Empire: The Web of Control*, in *A GAME AS OLD AS EMPIRE: THE SECRET WEB OF ECONOMIC HIT MEN AND THE WEB OF GLOBAL CORRUPTION* 13, 17 (Steven Hiatt ed., 2007).

operate.

The primary remedy Control First proponents advocate is to increase national governments' control of individuals' and firms' actions in the expanded international arena outside of the governments' own jurisdictions, rather than focusing national regulation on bad actors in the jurisdiction where bad acts occur. For example, with respect to recent reports that \$750 million is missing from the Angolan treasury in a corruption case, Corruption Watch UK argues that the money was stolen from the Angolan and Russian governments through the use of "an unnecessary middleman, Abalone Investments" which "made hundreds of millions of dollars in profit from the transaction despite offering no discernible services or value, at the expense of the Russian and Angolan treasuries." As a result, Corruption Watch U.K. alleges that "[a] number of Russian and Angolan individuals, including . . . the richest member of Russia's Duma . . ., benefited from the deal, and Swiss Bank Corporation (SBS), which through merger later became UBS, facilitated it."<sup>128</sup> In short, Corruption Watch U.K. alleges that individuals in the Angolan and Russian governments conspired to steal money from their governments by routing a government-to-government transaction through a firm with ties to Switzerland and the Isle of Man.

Although critical of the Russian or Angolan portions of the transaction, Corruption Watch U.K.'s report emphasizes the roles of actors in Switzerland, Isle of Man (where Abalone was created), and elsewhere.<sup>129</sup> This suggests, at least implicitly, that something about Swiss or Manx law makes corruption more likely than if the transaction were limited to Angolan and Russian legal structures. However, Corruption Watch U.K. provides no actual evidence that either Angolan or Russian law is better at preventing corruption than Swiss or Manx law. In fact, there is evidence that this is not true. Angola ranked 157th on Transparency International's Corruption

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128. Associacao Maos Livres & Corruption Watch U.K., *Deception in High Places: The Corrupt Angola-Russia Debt Deal* 9 (2013) available at <http://www.cw-uk.org/wp-content/uploads/2013/04/The-Corrupt-Angolan-Russian-Debt-Deal-Full-Report.pdf>.

129. Of course, no firm or individual in either Switzerland or the Isle of Man could have accomplished the allegedly corrupt transactions without the active participation of individuals with positions of responsibility in both the Russian and Angolan governments. It thus seems peculiar to focus primary attention on governments other than Russia and Angola.

Perceptions Index, Russia ranked 133rd, while Switzerland ranked 6th (the Isle of Man was not ranked but the United Kingdom was ranked 17th)<sup>130</sup> This assumption that the use of Swiss and Marx legal persons is *prima facie* bad, rather than the normal workings of an efficient market, suggests that Corruption Watch U.K. has a Control First view. Moreover, it assumes, rather than demonstrating through a cost-benefit analysis, that the appropriate remedy for the failure of the Russian and Angolan legal and political systems to control corruption is to impose controls in Switzerland and the Isle of Man. This is an assumption of heroic proportions. An alternative account for corruption stresses "bad regulation. Ill-designed policies create corrupt incentives for policy makers, bureaucrats and the public in general."<sup>131</sup> ("Bad" regulations include those that are "vague and lax."<sup>132</sup>)

Although they sometimes concede there are some positive impacts of globalized financial markets and increased trade,<sup>133</sup> Control First proponents focus almost exclusively on increasing governments' control over financial transactions to control the bad effects. They argue this is necessary for three reasons. First, they contend that the global financial system makes it possible for bad

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130. *Corruption Perception Index 2012*, TRANSPARENCY INTERNATIONAL (Oct. 27, 2013), <http://cpi.transparency.org/cpi2012/results/#myAnchor1> (lower scores reflect lower perception of corruption). Interestingly, among the 25 least corrupt jurisdictions on this index, there are six (Singapore (5th), the Netherlands (9th), Luxembourg (12th), Hong Kong (14th), Barbados (15th), and the Bahamas (22nd)) which have substantial offshore financial center roles. *Id.* Nor do Russia or Angola appear to provide accountability for public officials. Miller and Cafaggi define accountability as requiring that "the officials who adopt and implement the arrangement: (a) follow transparent procedures that take account of the interests of all affected parties (procedural accountability); (b) are appointed and supervised under a governance structure that gives a substantive voice to all affected parties (governance accountability); and (c) are rewarded or sanctioned for their performance by the relevant public on the basis of accurate information (substantive accountability)." MILLER & CAFAGGI, *supra* note 35, at 133. Placing the burden for the lack of accountability in Russia and Angola on Switzerland and the Isle of Man is not only unfair to those jurisdictions but has little hope of success since those jurisdictions have little influence on the construction of domestic political institutions elsewhere.

131. Lambsdorff, *supra* note 29, at 6.

132. *Id.* at 7. See also Daniel Kaufmann et al., *Measuring Governance Using Cross-Country Perceptions Data*, in INTERNATIONAL HANDBOOK ON THE ECONOMICS OF CORRUPTION 52, 52 (Susan Rose-Ackerman ed., 2006) ("in the past 10 years there has been an explosion of careful empirical work that has documented a strong causal link running from better institutions to better development outcomes.").

133. Henry, *supra* note 4, at 25.

actors to engage in more bad activity than they would be able to accomplish in a less financially open environment. For example, *The Price of Offshore Revisited* argues that private banks and law firms are engaged in "pirate banking" by "hiding and managing offshore assets for the world's elite."<sup>134</sup> Second, they argue that greater financial openness produces greater tax evasion and tax avoidance, which deny governments revenues needed to provide public goods. Thus *The Price of Offshore Revisited* contrasts the "hidden wealth" going untaxed with "governments around the world [which] are starved for resources."<sup>135</sup> Third, they argue financial openness constrains the ability of governments to adopt policies that the governments believe are beneficial. For example, Palan argues that offshore finance is the space where "states choose to withhold some or all of their regulations and taxation."<sup>136</sup> The result is to "subvert" public regulation of onshore jurisdictions, which "is supposed to be the imposition of political control and norms of behavior for social ends."<sup>137</sup> In general, Control First proponents focus on illegitimate ends that *might* be pursued within a global economy in which transactions are not carefully regulated by competent and benevolent governments.<sup>138</sup> Where particular governments are incompetent or malevolent, other jurisdictions' governments must act to control bad actors.<sup>139</sup>

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134. *Id.* at 43.

135. *Id.* at 40. Although Henry and TJN do not explicitly link to his views, this is an argument that goes back to John Maynard Keynes' post-World War II argument that capital flows could be disaggregated into cross-border investment capital that was productive and speculative and refugee capital that was destabilizing. ALEXANDER ET AL., *supra* note 2, at 85. If Keynes was ever correct, the increased complexity of capital flows today makes this implausible in our view.

136. Palan, *supra* note 3, at 25.

137. *Id.* at 36. For an organization that supposedly loves transparency, TJN provides remarkably little of it in the report.

138. Strangely, the Tax Justice Network believes that "many key 'source' countries don't even have domestic income tax regimes in place, let alone the power to enforce such taxes across borders." Henry, *supra* note 4, at 42. If these countries have no income tax (or no functional income tax), the reasons their wealthy citizens are moving money out of the country do not seem to be tied to taxation.

139. *Id.* at 43 ("developed countries have a responsibility as well as the capacity to help [developing countries] solve" the tax problems). In addition, "institutions like the World Bank, the IMF, the U.S. Federal Reserve, the Bank of England, and the Bank for International Settlements" must "live up to their promises, and work with organizations like TJN on a research and policy agenda that finally gives this offshore sector the attention it deserves." *Id.* at 45. That would certainly solve TJN's

It follows that the limits on governments imposed by capital markets are illegitimate. For example, Hampton and Abbott argue that

since 1992 we have witnessed a catalogue of economies and government policies wrecked by speculation and rapid capital flight. Since the 1992 ERM crisis forced the UK government to take sterling out of Europe's fixed exchange rate system at a cost of over \$10 billion in foreign currency reserves, the financial markets appear to have taken one scalp after another, from Mexico in 1994 to a whole series of economies across Asia between 1997 and 1998 whose collective collapse threatens to have global consequences. Even as this book was being completed (August 1998) there was the spectacle of Boris Yeltsin being forced to devalue the ruble only three days after he and his finance minister had adamantly resisted calls from the most famous of speculators, George Soros, to do so. In Indonesia the financial crisis even brought down the country's ageing President, Suharto, after 32 years in power.<sup>140</sup>

These examples are revealing, as each reflects a government's inability to maintain fixed exchange rates in the face of market pressures. One interpretation of these failures is that it is the speculators (such as Soros, who profited significantly from the U.K.'s failure to maintain the value of sterling) who are responsible for the problems, rather than the governments that adopted dysfunctional policies. Control First framework proponents often suggest this is the appropriate way to view such events, rather than seeing them as a failure of a government to make appropriate policy decisions, which allows a clever or lucky individual like Soros to profit by risking his capital in betting that the government cannot sustain a dysfunctional policy against market pressures.<sup>141</sup> Because

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funding issues for the foreseeable future! Unmentioned by TJN are the many conflicts over policy objectives that underlie particular choices of tax structures. For example, a key role of multi-jurisdictional tax planning for individuals concerns their estate plans, including who gets the estate. National tax systems differ in their treatment of estates. See Helmuth Cremer & Pierre Pestieau, *Wealth and Wealth Transfer Taxation: A Survey*, in ELGAR GUIDE, *supra* note 7, at 183, 189 (describing how inheritance tax systems and estate tax systems reflect "quite different" conceptions of the family and state).

140. Hampton & Abbott, *supra* note 1, at 14.

141. For example, Britain's exit from the ERM, the Russian and Mexican devaluations, and the various Asian currency collapses might be attributable to failures of the governments in question to have sustainable fiscal and monetary policies rather than malevolent action by speculators.

Control First proponents appear to not recognize as legitimate *any* limits to government actions other than the limits they themselves propose (e.g., restrictions on tax competition), they see all market-derived limits primarily as the result of illegitimate private actions. In particular, they appear to believe that any government ought to be able to dictate any exchange rate the government believes is useful to it. Moreover, they do not appear to recognize that any governments might be illegitimate. That a financial crisis brought down former Indonesian dictator Suharto, whose rule the *New York Times*' story on his death termed "one of the most brutal and corrupt," might be a feature of globalized finance rather than a bug.<sup>142</sup>

Control First proponents also find efforts by attorneys and accountants to structure transactions in ways beneficial to their clients to be problematic. "[T]he scope of the state's power to regulate private activities and transactions in world markets is elastic," thus enabling the use of "creative lawyers" to "accommodate formal legal requirements to the strategies of capital accumulation."<sup>143</sup> Using "abstract legal concepts, or fictions," these lawyers then can pursue strategies to minimize taxes.<sup>144</sup> According to these Control Firsters, such efforts are "distortions" or involve something other than "real" economic activity. As a result, these efforts are illegitimate.

Control Firsters argue that the answer to all of these problems is to control the movement of money; the absence of such measures evades what they see as legitimate social controls. In particular, if all the beneficial owners and controllers of interests in all transactions were identified, all transactions could be regulated, taxed, or simply stopped by governments when a government determined that a particular transaction was illegitimate. Thus, for example, the Tax Justice Network contends "nation-states need to work together to take steps now to [take] control over all this out-of-control global

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142. Marilyn Berger, *Suharto Dies at 86; Indonesian Dictator Brought Order and Bloodshed*, N.Y. TIMES (Jan. 28, 2008), [http://www.nytimes.com/2008/01/28/world/asia/28suharto.html?pagewanted=all&\\_r=0](http://www.nytimes.com/2008/01/28/world/asia/28suharto.html?pagewanted=all&_r=0)

143. Picciotto, *supra* note 7, at 47. He also attributes the creation of tax haven jurisdictions to "enterprising lawyers or accountants who could persuade government officials or legislators to enact the necessary provisions." *Id.* at 53.

144. *Id.* at 47-48.

'financial pollution.'"<sup>145</sup> Doing this requires "automatic information exchange among tax authorities, country-by-country corporate reporting, and the deployment of public registries for beneficial ownership of companies, trusts, and foundations."<sup>146</sup> In addition, there need to be "stiffer sanctions" for "'pirate banking' misbehavior" by banks and bank managers.<sup>147</sup> A successful approach will limit not just behavior of OFCs but also jurisdictions within larger countries: Nevada and Delaware will have to be "curb[ed],"<sup>148</sup> presumably in part because they register many companies whose owners do not live in those jurisdictions.

Such expanded control measures are not merely hypothetical proposals. Recent proposed regulations by the Financial Crimes Enforcement Network (FinCEN), designed to improve anti-money laundering controls (discussed in further detail below) would require financial institutions to identify, on a current basis, the ultimate human beings who are the beneficial owners and controllers of *all* their clients (with some exemptions, e.g., for publicly listed companies), without regard to whether there is any suspicion that such persons might be engaged in illegal activities.<sup>149</sup> While this proposal has resulted in significant push-back from regulated financial institutions and others,<sup>150</sup> the fact that FinCEN seeks to implement a requirement of the Financial Action Task

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145. Henry, *supra* note 4, at 44. One of the endearing features of *The Price of Offshore Revisited* is that it appears to not have been proofread and so contains quite a few typos, missing words, etc. This does not inspire confidence in the unreleased details of the calculations.

146. *Id.*

147. *Id.* These are extraordinary steps, much harder and costlier than they appear. Countries without direct taxation do not collect the same information as countries that rely on direct taxation. Who funds the collection of information that must be exchanged "automatically?"

148. *Id.*

149. 77 Fed. Reg. 13,046 (Mar. 5, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-03-05/pdf/2012-5187.pdf>. However, recent FinCEN guidance does include a risk-based concept to beneficial owner identification. Guidance on Obtaining and Retaining Beneficial Ownership Information, FIN-2010-G001 (Mar. 5, 2013), available at [http://www.fincen.gov/statutes\\_regs/guidance/pdf/fin-2010-g001.pdf](http://www.fincen.gov/statutes_regs/guidance/pdf/fin-2010-g001.pdf).

150. See, *Customer Due Diligence Requirements for Financial Institutions*, REGULATIONS.GOV <http://www.regulations.gov/#!docketDetail;dct=PS;rpp=25;po=0;D=FINCEN-2012-0001> (Last visited Oct. 29, 2013). The requirement to identify beneficial owner and controller of accounts is also central to the Foreign Account Tax Compliance Act, discussed below at 3.



Force's (FATF) global anti-money laundering standards suggest that some version of it will ultimately be enacted.<sup>151</sup> Such requirements would be exceptionally difficult to implement in such a way as to catch actual "bad guys" intent on avoiding detection. Moreover, they would generate significant additional costs by requiring financial institutions to identify ultimate beneficial owners and controllers in the vast majority of clients who are not involved in illegal activities.<sup>152</sup> (They are also highly unlikely to be capable of being implemented in many developing countries.)<sup>153</sup> But for the Control Firsters, adding significant costs to legitimate financial activities is not a primary concern. (Nor, perhaps, is the effectiveness of the controls demanded in accomplishing the stated objective of reducing crime, as we discuss below). Adding complexity to tax codes is also problematic: Vito Tanzi analogizes it to "termites" which "weaken the structure, increase the complexity of the systems and the cost of compliance, and reduce the efficiency and the equity of the tax systems" and argues compliance costs are a regressive tax.<sup>154</sup>

The Control First vision focuses on four key policy areas. First, its proponents believe that controlling crime via efforts to limit the ability of criminals to make use of the proceeds of crime is an important law enforcement tool, a view also adopted by most Efficient Enterprisers. This has been important in persuading

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151. Recommendations 10, 24, and 25, Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation 15, 22 (2012) (hereinafter FAFT 40), available at <http://www.fatf-gafi.org/topics/fatfrecommendations/documents/internationalstandardsoncombatingmoneylaunderingandthefinancingofterrorismproliferation-thefatfrecommendations.html>. One reason to believe that the FATF will continue to be influential is that it has already had "an extraordinary impact on the development of international norms to combat financial crime and money laundering." ALEXANDER ET AL., *supra* note 2, at 150.

152. The easiest being to use a confederate or front person as the beneficial owner/controller, and to lie about it.

153. If developing countries have trouble with institution-level regulation for financial firms —as they do—we think it improbable that the more demanding beneficial ownership regulation could be accomplished. On capital regulation in developing economies, see Philip L. Brock, *Corrective Taxes and Quasi-Taxes for Financial Institutions and Their Interaction with Deposit Insurance*, in *TAXATION OF FINANCIAL INTERMEDIATION: THEORY AND PRACTICE FOR EMERGING ECONOMIES* 169, 178 (2003) (noting problems with enforcing capital requirements regulations in developing countries because of regulatory issues).

154. Vito Tanzi, *Tax Systems in the OECD: recent evolution, competition, and convergence*, in *ELGAR GUIDE*, *supra* note 7, at 32–34.

jurisdictions to adopt Control First measures, since it is difficult to resist pressures to control crime. Second, they contend that corruption is best controlled by generally applicable controls on most or all international financial transactions. This is where they differ from Efficient Enterprisers, who believe that controls should be applied only on a cost effective basis. Third, Control Firsters believe that all governments should be unconstrained by international tax competition in designing domestic tax systems and every jurisdiction should have complete information on all transactions by any taxpayers who operate in it to facilitate collection of any tax any government wishes to impose. Fourth, they similarly believe that jurisdictional competition should impose no limits on any government's ability to redistribute resources among entities and individuals under its jurisdiction and that all governments must therefore have access to complete information on all of their citizens' wealth and income.

### *1. Controlling Crime via Money*

In the 1970s and 1980s, it became clear to most observers that the global "war" against illegal drugs trafficking was not working. Rather than rethink whether their strategies of prohibiting the use of narcotics was itself fundamentally flawed, or spend the necessary additional public resources to treat drug addiction, or take the additional draconian policing steps required to force the significant curtailing of domestic drug usage,<sup>155</sup> the United States and a number of other wealthy countries where drugs were imported to meet domestic demand began to focus instead on measures to reduce the profitability of the international drug trade by making it more difficult for those involved to use or invest the proceeds of their illegal activities.<sup>156</sup> They did so primarily by enlisting banks, and

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155. See Human Rights Watch, *Singapore*, in World Report 2011, available at [http://www.hrw.org/sites/default/files/related\\_material/singapore\\_2012.pdf](http://www.hrw.org/sites/default/files/related_material/singapore_2012.pdf) (noting use of death penalty for "some 20 drug-related offenses in the face of repeated criticism by UN human rights bodies and experts."). Singapore recently changed its laws to make the death penalty depend on the degree of cooperation with police and the degree of culpability. See *Drug courier escapes gallows after Singapore reforms*, AFP NEWS (Apr. 12, 2013), <http://sg.news.yahoo.com/drug-courier-escapes-gallows-singapore-reforms-161116337.html> (describing first drug defendant not to be sentenced to death).

156. Richard Gordon, *Trusts or Terrorists? Financial Institutions and the Search for Bad Guys*, 43 WAKE FOREST L. REV. 699, 712-719 (2008). Jurisdictions also began to implement provisions for civil forfeiture of property involved in drug crimes.

later, other financial institutions, as unpaid adjuncts of law enforcement agencies. In effect, financial institutions were required to identify exactly who their customers were, and to determine if the origin of their customers' funds or financial transactions might be the proceeds of narcotics trafficking (and, later, of other serious crimes such as corruption and tax evasion). If the institution suspected that the funds or transactions involved criminal proceeds, they were required to complete an internal investigation of those customers, funds, and transactions and file a report with the government. A key to this anti-money laundering program was the elimination of client confidentiality in financial matters.<sup>157</sup> In addition, financial institutions had to develop expertise in evaluating patterns of transactions and other indicia of illegal activity.<sup>158</sup> Over time, these anti-money laundering requirements were regularly extended and made more onerous, raising the costs to all customers.<sup>159</sup> This marked the first major international adoption of a Control First approach to financial transactions.

Efforts to control crime via financial institutions could not be effectively implemented by a single jurisdiction because of the interconnectedness of the global financial system. Those countries that took the lead in developing such anti-money laundering preventive measures founded an international task force, the FATF, both to standardize such measures and to encourage all jurisdictions to adopt them.<sup>160</sup> These international standards, now known as the FATF 40 Recommendations on Money Laundering and Terrorism Finance also include provisions regarding the freezing and forfeit of criminal proceeds and instrumentalities and international assistance in investigating and prosecuting crime, including the sharing of extensive and detailed client financial information. Over time, the FATF membership expanded to 34 jurisdictions,<sup>161</sup> including such

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Where these gave the law enforcement agency involved a larger share of the property, they tend to focus law enforcement attention on such crimes. See Bruce L. Benson, David W. Rasmussen, & David L. Sollars, *Police Bureaucracies, Their Incentives, and the War on Drugs*, 83 PUBLIC CHOICE 21 (1995).

157. Gordon, *Trysts*, *supra* note 156, at 712-719.

158. *Id.* at 726-27.

159. *Id.* at 712-19.

160. The G-7 Heads of State or Government and President of the European Commission convened the FATF from the G-7 member States, the European Commission and eight other countries. FATF, *History of the FATF*, available at <http://www.fatf-gafi.org/pages/aboutus/historyofthefatf/>.

161. *About Us*, FATF <http://www.fatf-gafi.org/pages/aboutus/> (last visited

emerging market countries as India and China, while allied regional organizations known as FATF-Style Regional Bodies or FSRBs have brought the number of jurisdictions pledged to implement the FATF's Recommendations to over 140.<sup>162</sup> Assessments of compliance with the Recommendations are undertaken by members based upon a detailed methodology of compliance, and are published on the websites of the FATF and FSRBs.<sup>163</sup> In addition, following the attacks of September 11th, 2001, the International Monetary Fund (IMF) and the World Bank began to participate in the compliance assessments.<sup>164</sup> The experience with the FATF Recommendations is thus a good model for assessing how Control First measures work in practice.

A key aspect of the Recommendations has long been that financial institutions must determine if financial institutions with which they do business in other jurisdictions comply with the Recommendations. If not, financial institutions must raise their own required due diligence or cease engaging in business with those non-compliant institutions.<sup>165</sup> Crucially, all of these measures rely heavily on conscripting financial service providers to implement control measures and on transnational bodies to evaluate compliance, shifting control of jurisdictions' financial systems out of their own hands and into bodies that may be controlled by others.<sup>166</sup>

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Oct. 28, 2013).

162. *Anti-Money Laundering and Combatting the Financing of Terrorism*, IMF <http://www.imf.org/external/np/leg/amlcft/eng/> (last visited Oct. 28, 2013).

163. *Id.*

164. *Id.*

165. Recommendations 13 and 19, FATF 40, *supra* note 151, at 16, 19.

166. While FATF preventive measures are a Control First unfunded mandate that forces financial institutions to engage in law enforcement, the mandate does not discriminate among those jurisdictions that are suffering the ill effects of crime and those that bear the increase in costs that the mandate generates. Richard Gordon, *Losing the War against Dirty Money: Rethinking Global Standards on Preventing Money Laundering and Terrorism Financing*, 21 DUKE J. COMP. & INT'L L. 503, 52944 (2011). For example, while the vast majority of the users of illicit narcotics (who are the source of illegal proceeds) tend to reside in large jurisdictions like the United States, other jurisdictions with fewer such problems, many of which are offshore centers, are required to bear the costs of the preventive measures. The same can be said of other serious predicate offenses like grand corruption and income tax evasion. (Grand corruption "consists of acts committed at a high level of government that distort policies or the central functioning of the state, enabling leaders to benefit at the expense of the public good." *FAQs on Corruption*, TRANSPARENCY INTERNATIONAL (Oct. 28, 2013) [http://www.transparency.org/whoweare/organisation/faq\\_on\\_corruption](http://www.transparency.org/whoweare/organisation/faq_on_corruption). As

A central activity of the FATF has been to determine which jurisdictions pose significant money laundering and terrorism financing risks and to encourage them to improve their systems. A primary part of such encouragement has been the threat of countermeasures, or requiring financial institutions from compliant jurisdictions to increase due diligence in transactions with institutions in non-compliant ones, or to stop engaging in business entirely with those financial institutions.<sup>167</sup> The first such initiative was the Non-Cooperative Country and Territories initiative, which began in the early part of the last decade.<sup>168</sup> There were a number of complaints about that initiative, focusing on what the IMF believed was a degree of arbitrariness in both the selection of which jurisdictions would be subject to special monitoring and the method for assessing compliance in those jurisdictions. The most recent version, the High Risk and Non-Cooperative Jurisdictions initiative, relies on a far more evenhanded and transparent approach to assessment and evaluation. It targets "jurisdictions that have strategic AML/CFT deficiencies and to which countermeasures apply, [and] jurisdictions with strategic AML/CFT deficiencies that have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies."<sup>169</sup>

Even though there is often no obvious benefit to them, offshore jurisdictions have become among the most compliant jurisdictions with the FATF 40. The High Risk and Non-Cooperative Jurisdictions

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noted earlier, the Control First approach is to impose control measures that raise costs on all with little or no discussion of the actual benefits achieved by the measures. Recently, however, the FATF has adopted new Recommendations that allow jurisdictions to apply preventive measures on a risk-weighted basis, and to assess compliance in part on effectiveness of implementation. While these changes are only now being implemented, they do demonstrate a new and commendable willingness on the part of the FATF to address some of the problems that arise under the Control First impulse. Recommendation 1, FATF 40, at 11. Recommendation 1, FATF 40, *supra* note 151, at 11.

167. *About the Non-Cooperative Country and Territories Initiative*, FATF (Oct. 28, 2013) <http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions/more/aboutthenon-cooperativecountriesandterritoriesncctinitiative.html>.

168. For a history of the FATF's Non-Cooperative Country and Territories Initiative and the Offshore Financial Center assessment process, see Richard Gordon, *On the Use and Abuse of Standards for Law: Global Governance and Offshore Financial Centers*, 88 N.C.L. REV. 510, 572-584 (2010).

169. *High Risk and Non-Cooperative Jurisdictions*, FATF (Oct. 28, 2013) <http://www.fatf-gafi.org/topics/high-riskandnon-cooperativejurisdictions>.

initiative includes only one traditional offshore center, Antigua and Barbuda, and that only on the "Improving Global AML/CFT Compliance: on-going process" list.<sup>170</sup> Indeed, Jersey and Guernsey have been assessed as the jurisdictions that are most compliant with the FATF standards.<sup>171</sup>

In effect, jurisdictions that do not themselves suffer the ill effects of predicate crimes to money laundering have raised the costs of financial transactions implemented through financial institutions located within their jurisdictions for the purpose of fighting crime that occurs elsewhere and which adversely affects the citizens of other places rather than their own citizens. This has been particularly true with respect to measures directed against the use of offshore centers by corrupt foreign officials. Recent studies by the World Bank and noted scholar Jason Sharman conclude that among the most compliant jurisdictions with respect to the laundering of proceeds of corruption are offshore centers, while among the least are the United States and the United Kingdom.<sup>172</sup>

Broader costs can also be observed. Anti-money laundering compliance costs on low value transactions may have significant effects on the poor and minorities who have little money to spare.<sup>173</sup>

There are three key lessons from the FATF 40 experience with Control First measures. First, they are imposed by a small group of powerful jurisdictions on the rest of the world, often without effective broad participation. Second, they may shift costs from the jurisdictions that benefit to other, generally smaller jurisdictions and

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170. *Id.*

171. *Onshore Financial Centers: Not a palm tree in sight*, ECONOMIST, Special Report, Feb. 16, 2013, at 8.

172. EMILE VAN DER DOES DE WILLEBOIS, EMILY M. HALTER, ROBERT A. HARRISON, JI WON PARK & J. C. SHARMAN, *THE PUPPET MASTERS: HOW THE CORRUPT USE LEGAL STRUCTURES TO HIDE STOLEN ASSETS AND WHAT TO DO ABOUT IT* (2012); Shima Baradaran, Michael Findley, Daniel Nielson & J. C. Sharman, *Does International Law Matter?*, 97 MINN. L. REV. 734, 826-837 (2013). There is also "at least some support for the argument that corruption and taxation are substitutes." Bird, *supra* note 24, at 415. This would greatly complicate TJN's analysis.

173. See Nina J. Crimm, *High Alert: The Government's War on the Financing of Terrorism and Its Implications for Donors, Domestic Charitable Organizations, and Global Philanthropy*, 45 WM. & MARY L. REV. 1341 (2004) (discussing extensively the liabilities imposed by the U.S. on charitable donations by antiterrorism financing laws). The increasing attention of financial regulators to microfinance initiatives is another example of how regulatory goals sometimes conflict with attempts to improve the financial status of the world's poor. See MILLER & CAFAGGI, *supra* note 35, at 78-79.

the private sector by requiring expensive compliance and monitoring measures to benefit others; they may as well adversely affect the poor more than the wealthy. Third, neither the standards' efficacy nor their cost-effectiveness are regularly discussed once they are promulgated. Fortunately, under the FATF's current leadership, the third point at least is no longer the case, where efficacy and cost-effectiveness are increasingly important in the design and implementation of FATF standards (discussed below).

## 2. *Deterring Corruption*

Once the Control First approach was established in anti-drug crime efforts, proponents soon sought to expand it to control other problems. In particular, the widespread publicity surrounding a number of banking scandals involving corrupt individuals in the 1970s and 1980s led to efforts to control corrupt politicians in one country via banking controls in other countries.<sup>174</sup> Proponents of the Control First framework see transnational financial institutions as playing a key role in the theft of assets from developing country governments. For example, James Henry argues that there is a "general phenomenon" of "the export of vast quantities of capital and tax-free incomes by the elites of poor countries, even as their countries were incurring vast debts and struggling to service them. Individual kleptocratic regimes and evil dictators come and go, but this sophisticated transnational system remains more vibrant than ever."<sup>175</sup> "Preeminent global financial institutions" facilitate a series

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174. See JONATHAN BEATY & S.C. GWYNNE, *THE OUTLAW BANK: A WILDE RIDE INTO THE SECRET HEART OF BCCI* (2004) (describing the BCCI scandal); James Adams & Douglas Frantz, *A FULL SERVICE BANK* (1993) (same); Timothy L. O'Brien, *At Riggs Bank, A Tangled Path Led to Scandal*, N.Y. TIMES (July 19, 2004) <http://www.nytimes.com/2004/07/19/us/at-riggs-bank-a-tangled-path-led-to-scandal.html?pagewanted=all&src=pm> (describing corruption scandal at Riggs Bank involving accounts for foreign government officials); U.S. Congress, House of Representatives, *Risk Management and Regulatory Failures at Riggs Bank and UBS: Lessons Learned* (2010).

175. HENRY, *BLOOD BANKERS* *supra* note 9, at xxv. A problem for Control First framework proponents is that some of the policies they object to are the result of domestic politics in developing economies. For example, Henry notes that the Bangko Sentral ng Pilipinas (the Philippine Central Bank), "under pressure from domestic interest groups to maintain a strong peso, low taxes and interest rates," borrowed money that financed the peso's appreciation from 1976 to 1982. The result was a growth in imports and capital flight, including by business people, lawyers, accountants, doctors and dentists. *Id.* at 68. The problem is that those "squirreling" away money outside the Philippines were behaving rationally — faced both with an overvalued domestic currency and the political risk that the Marcos

of “perverse capital flows.”<sup>176</sup> This has led to a “global bleed-out” of assets from developing economies.<sup>177</sup> This includes “wasteful projects and arms purchases,” the use of “[h]undreds of billions of Third World loans” for “nonproductive projects and corruption,” many of which had “harmful long-term consequences.”<sup>178</sup> A

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regime would end (a risk that was increasing over time). Similarly, Henry’s complaint that Venezuelans “decapitalized” their economy during the late 1970s and early 1980s when the bolivar was “seriously overvalued” making dollars cheap, mistakenly ignores the rationality of the behavior of those who sought to escape a currency that would inevitably devalue for the safety of an alternative. *Id.* at 104. To the extent that it was politicians “stashing away government revenues and foreign aid funds in numbered accounts” and helping to precipitate financial crises, the problem is as much an internal one as it is an external one. *See* STOPFORD, STRANGE & HENLEY, *supra* note 11, at 105. Moreover, even in Henry’s account, the Philippines’ problems stemmed in significant part from theft of gold from the Central Bank—an illegal act that occurred in the Philippines. HENRY, BLOOD BANKERS, *supra* note 9, at 71–72. The Philippine example is not the only one. Henry also points to Venezuela’s practice of borrowing money for development projects from international banks while depositing oil revenues in those same banks under President Carlos Andres Perez. Henry explains this as a mechanism to siphon off funds to the bank accounts of Pres. Perez and other Venezuelan officials. *Id.* at 98–99. Among other means of doing so, Henry argues that Venezuelan government agencies circumvented legal restrictions on long term borrowing by switching to short term loans. *Id.* at 102–103. Similarly, he argues that Argentine central bankers facilitated looting the country. *Id.* at 244–245. More of the problems—as Henry admits—come from “the highest rate of tax evasion in Asia” because “tax resistance is deeply engrained in Filipino attitudes” after “twenty-one years of dictatorship and a parade of corrupt administrations” and “an extraordinary number of tax concessions” made to businesses and individuals. *Id.* at 84. Even when a government complicit in this activity is toppled, Control First framework proponents object to developed countries’ legal obstacles to returning allegedly stolen assets. *See, e.g., id.* at 48 (“Overall, it turns out that if the loot is large enough, leading havens like Switzerland, Liechtenstein, and the US as well as the court systems in developing countries, are much more scrupulous about returning stolen property than about receiving, protecting, and concealing it in the first place.”).

176. HENRY, BLOOD BANKERS, *supra* note 9, at xxvii.

177. *Id.*

178. *Id.* Opinions may differ on what constitutes a ‘wasteful’ project, of course. Reviews of multinational companies’ projects in developing countries have found large numbers of “negative economic outcomes” associated with projects “where government offered high rates of tariff protection for import-substituting projects.” STOPFORD, STRANGE & HENLEY, *supra* note 11, at 151–52. It is not clear that Henry would count a project as “wasteful” simply because it had a negative economic return. There is certainly no shortage of poorly conceived and/or poorly executed development projects funded through international borrowing by developing country governments. (Richer governments can fund such projects on their own.) But it is also true that “greater capital mobility has permitted many governments ... to initiate development projects that previously had been starved by capital shortage and has helped raise the levels of ambition for future competitiveness and importance on the world stage.” *Id.* at 34. Not all of these projects were misguided



"sophisticated *transnational system* of influential institutions," rather than "random policy mistakes" or "purely indigenous corruption," contrived to produce similar mistakes over and over again, in every region of the world."<sup>179</sup> This is the result of "an interlocking global system of institutions and interests," which is "self-organizing" and "consists of an amazing array of mutually reinforcing interests" that "takes no prisoners."<sup>180</sup> Control First proponents argue that to overcome this problem requires ever tighter controls over the financial institutions that make the looting possible.

A key component of this argument is that developing countries misapply the proceeds of the loans they receive. For example, in *Blood Bankers* Henry argues that the Philippines' problem was "not so much over borrowing per se, but the question of what was done with the money."<sup>181</sup> In *The Price of Offshore Revisited*, he argues that "private elites" in developing countries "accumulated \$7.3 to \$9.3 trillion of unrecorded offshore wealth" from the 1970s to 2010, even as their governments borrowed \$4.08 trillion, and their economies proved to be the source of \$10.1 to \$13.1 trillion of capital exports.<sup>182</sup> The private capital exports and public debts are "intimately

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or poorly executed.

179. HENRY, *BLOOD BANKERS*, *supra* note 9, at xxviii. Henry repeatedly excuses foreign governments. Nicaragua's Sandinista regime is referred to as "courageous, well-meaning, and rather naïve young Marxists and social democrats" who "had almost no experience managing a small developing country." *Id.* at 183. Later, he concedes that the Sandinista-controlled central bank "printed cordobas like crazy" when the Sandinista's lost power in 1996 and admits the lame duck Sandinista legislature "rushed through several new laws that granted title for all this expropriated property to its current possessor—in most cases, FSLN party leaders and their supporters." *Id.* at 201–202.

180. *Id.* at 223. It should be mentioned that prior to the end of the cold war geopolitics most likely had a significant influence over the waste of assets by developing country governments. Western countries often tolerated the poor governance of developing countries, providing the developing country governments supported the geopolitical goals of the western countries. See, e.g., GEORGES NZONGOLA-NTALAJA, *THE CONGO: FROM LEOPOLD TO KABILA* (2002).

181. HENRY, *BLOOD BANKERS*, *supra* note 9, at 66. Similarly, Argentina's heavy borrowings during the twentieth century was caused by "[l]eading international banks" not bad policies in Argentina. The banks "not only provided a huge amount of finance for misguided government spending" but also "private tutorials to Argentina's elite on how to move vast amounts of their 'rich' country's wealth to New York, Miami, and Switzerland." *Id.* at 226–227. Yet Henry concedes that "[a]nyone could see that the junta's economic policies, on top of the repression, were approaching a dead end." *Id.* at 242. The alternative was for Argentines simply to accept devaluation losses.

182. Henry, *supra* note 4, at 5–6.

linked.”<sup>183</sup>

The Control First framework recognizes the problem of weak domestic institutions within the “exploited” jurisdictions. For example, Henry notes that Venezuela’s banking supervisor in the 1970s and 1980s had only six professional auditors for its banking sector and “limited enforcement powers,” while the banks were “protected from oversight by heavyweight political connections.”<sup>184</sup> Moreover, the Tax Justice Network complains that, “many key ‘source’ countries don’t even have domestic income tax regimes in place, let alone the power to enforce such taxes across borders.”<sup>185</sup> The solutions offered by Control First framework proponents to these problems are not to strengthen the weak institutions (although they presumably would not object to doing so), but to prevent the transfer of wealth from developing countries to financial institutions outside them and change laws to allow later governments to recover what they allege is previously looted wealth.<sup>186</sup>

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183. HENRY, *BLOOD BANKERS*, *supra* note 9, at 6. Similarly, Henry complains of the role of international institutions in the promotion of coffee growing in Vietnam, which turned out to be a lower cost producer than many Central American countries. *Id.* at 214. Despite support for the policy from Vietnam’s authoritarian government, Henry finds the problem was in the World Bank and other international lenders’ pressure on Vietnam to liberalize its economy. *Id.* at 212–13. Indeed, almost nothing cannot be excused by Henry in his search for oppressive behavior by international financial institutions: even Saddam Hussein’s invasion of Kuwait was the act of “a bungler, driven into a corner by his country’s economic crisis and isolation,” Kuwaiti “insults,” and Henry’s view of that Kuwait was an illegitimate British construction rather than a nation. *Id.* at 307, 355, 358, 362.

184. *Id.* at 112. Henry appears to see no contradiction between such points and his acceptance of the later Chavez government’s assertion that the Venezuelan state oil company, PDVSA, had had too much autonomy which required the government to take control of its finances. *Id.* at 120. On the problems with the Chavez-run PDVSA, see Peter Wilson, *Venezuela’s PDVSA Oil Company Is Bloated, ‘Falling Apart’*, USA TODAY (May 28, 2012), available at <http://usatoday30.usatoday.com/money/world/story/2012-05-28/venezuela-oil/55248628/1>; Jason Simpkins, *Hugo Chavez is Dead, But His Legacy of Inefficiency Will Live On*, OIL & ENERGY DAILY (Mar. 7, 2013), <http://www.oilandenergydaily.com/2013/03/07/hugo-chavez-pdvsa/>. He also ignored the widespread consensus that the pre-Chavez PDVSA was a model of efficiency and transparency. For example, William Ascher noted that PDVSA had “escaped the rampant inefficiency and corruption that are so prevalent in state oil companies in other many countries” and achieved “relative competence, cost consciousness, professionalism, and efficiency” precisely because the pre-Chavez governments had not “used the firm as a serious off-budget laundering mechanism.” WILLIAM ASCHER, *WHY GOVERNMENTS WASTE NATURAL RESOURCES: POLICY FAILURES IN DEVELOPING COUNTRIES* 221 (1999).

185. Henry, *supra* note 4, at 42.

186. *Id.* at 42, 43 (“For developing countries, then, the true so-called

As with the crime control measures described above, the Control First prescription for corruption is a set of standards dictated by a small group of countries and NGOs to be imposed by fiat on other jurisdictions. Much of the costs will be borne by jurisdictions and institutions with little or no say in the development of the standards. This focus is a step backward from the needed examination of the drivers of corruption in particular circumstances. As Mushtaq Khan argues, the "critical question" is identifying the type of corruption problem a society faces.<sup>187</sup>

### 3. *Deterring Tax Avoidance and Tax Evasion*

Many Control First proponents appear to believe that there is a "correct" (or perhaps "fair") amount of tax owed on any particular amount of income, that any effort to reduce that amount is illegitimate, and that such efforts are, or ought to be, illegal. Thus, they rarely distinguish between tax evasion (breaking the law) and legitimate tax planning (structuring one's affairs to reduce the tax owed while complying with the law). For example, Prof. Phyllis Lai Lan Mo argues that "[t]here is little doubt that all cases of tax avoidance are at odds with national interest"<sup>188</sup> and she sees "the distinction between avoidance and evasion" as "tenuous at best in practice."<sup>189</sup> Similarly, the Tax Justice Network "feel[s]" that it has "effectively demolished pretty much every" argument in favor of offshore financial centers playing a positive role.<sup>190</sup>

For Control First proponents, taxes are central to most international financial transactions. For example, Picciotto asserts that "the main spur for the creative exploitation of disjunctures in the international state system has been the avoidance of taxation."<sup>191</sup> Tax avoidance, or at least that degree of it which is contrary to the

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'development finance' problem is precisely that all this unrecorded wealth is now offshore, in the hands of private bankers and their own rapacious elites. That means their 'debt' problem has really become a tax justice problem—one that the developed countries have a responsibility as well as the capacity to help them solve.").

187. Mushtaq H. Khan, *Determinants of corruption in developing countries: the limits of conventional economic analysis*, in INTERNATIONAL HANDBOOK ON THE ECONOMICS OF CORRUPTION 216, 242 (Susan Rose-Ackerman ed., 2006).

188. PHYLLIS LAI LAN MO, TAX AVOIDANCE AND ANTI-AVOIDANCE MEASURES IN MAJOR DEVELOPING ECONOMIES 1 (2003).

189. *Id.* at 3.

190. Henry, *supra* note 4, at 25.

191. Picciotto, *supra* note 7, at 48.

intent of the government that proposed the tax law, is seen as the moral equivalent of breaking the law and potentially illegal in its own right. Thus, when the band U2 moved its music publishing company from Ireland to the Netherlands, saving substantial sums in taxes because of the Netherlands' favorable treatment of royalty income relative to Ireland's, the band was engaged in tax avoidance: legal behavior to minimize its taxes.<sup>192</sup> One might criticize this strategy on the grounds that the band had some kind of moral obligation to pay more taxes than the letter of the law required, but there was nothing illegal about its behavior.<sup>193</sup> Similarly, complaints in the United Kingdom over Starbucks' and Amazon's tax strategies, which reduced their U.K. tax bills, brought complaints from U.K. Prime Minister David Cameron and others that they were "immorally" minimizing their taxes; Cameron told MPs that he would make "damn sure" that such companies paid their fair share of U.K. taxes.<sup>194</sup> Prime Minister Cameron rejected the notion that being "within the law" was sufficient; "really aggressive tax avoidance" might be legal but would not be "playing fair."<sup>195</sup> As a result, Starbucks has begun making substantial payments in excess of its legal obligations to the U.K. government.<sup>196</sup> Both Democratic

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192. Robert Mackey, *U2 Responds to Critics of Their Deal with the Taxman*, N.Y. TIMES: (Feb. 27, 2009) <http://thelede.blogs.nytimes.com/2009/02/27/u2-respond-to-critics-of-their-deal-with-the-taxman/>.

193. The controversy over the move is summarized in Mackey, *Id.*, that notes that the charge that U2 was hypocritical for advocating for greater aid to developing countries while avoiding Irish taxes depending on U2's charitable work. Had U2 simply spent all its money on itself, there would be no hypocrisy in making the tax move. *Id.* U2 responded to the charge of hypocrisy by arguing that Ireland had itself lured business to its economy through low tax rates. Therefore, Bono contended that

What's actually hypocritical is the idea that then you couldn't use a financial services center in Holland. The real question people need to ask about Ireland's tax policy is: 'Was the nation a net gain benefactor?' and of course it was—hugely so. So there was no hypocrisy for me—we're just part of a system that has benefited the nation greatly and that's a system that will be closed down in time. Ireland will have to find other ways of being competitive and attractive.

*Id.*

194. Christopher Hope, *David Cameron: Tax avoiding foreign firms like Starbucks and Amazon lack 'moral scruples'*, THE TELEGRAPH, (Jan. 4, 2013), <http://www.telegraph.co.uk/news/politics/david-cameron/9779983/David-Cameron-Tax-avoidingforeign-firms-like-Starbucks-and-Amazon-lack-moral-scruples.html>.

195. *Id.*

196. Terry Macalister, *Starbucks pays corporation tax in UK for first time in five years*, GUARDIAN, (June 23, 2013), <http://www.theguardian.com/business/2013/ju>

and Republican members of the U.S. Senate have leveled similar complaints at Apple when they noted that Apple has used Irish subsidiaries to reduce the amount of income tax owed the U.S. Treasury.<sup>197</sup> While Apple was simply applying the law as enacted by the U.S. Congress, there seemed to be a view that the company should, in effect, voluntarily increase the amount of tax it paid.<sup>198</sup> Thus, Control First proponents contend that there is a “fair” allocation of tax independent of what tax laws actually say. Tax laws are thus seen as something other than the messy process of complex bargaining among interest groups within governments, often pursuing multiple and even contradictory objectives.<sup>199</sup> Rather they are “the main link between state and citizen, and are experienced as the most direct intervention by the state in economic activity.”<sup>200</sup> Moreover, by not taking into account the entire tax codes they compare, anti-tax competition activists mistake

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n/23/starbucks-pays-corporation-tax (quoting Starbucks that decided to forgo certain deductions which would make us liable to pay £10m in corporation tax this year and a further £10m in 2014. We have now paid £5m and will pay the remaining £5m later this year.”).

197. *Biting Criticism*, ECONOMIST, (May 21, 2013), <http://www.economist.com/blogs/schumpeter/2013/05/apples-tax-arrangements> (discussing criticism of Apple over its international arrangements).

198. Dominic Rushe, *Senators accuse Apple of ‘highly questionable’ billion-dollar tax avoidance scheme*, GUARDIAN, (May 20, 2013), <http://www.theguardian.com/technology/2013/may/20/apple-accused-tax-avoidance-billions-scheme> (noting that U.S. Senator John McCain said his constituents were “mad as hell” to learn that Apple was paying tax rates that were sometimes lower than 1%. “I’ve never seen anything like this.” While Apple argued that “Apple complies fully with both the laws and spirit of the laws. And Apple pays all its required taxes, both in this country and abroad.”).

199. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 135.

A state has objectives that are multiple, often conflicting, always shifting. It cannot in reality be a rational actor in the game-theory sense of having a fixed order of priorities in its policy goals. It always wants incompatible, conflicting values. It wants to be efficient and competitive *and* to preserve social peace and the cohesion of the state with society. It wants autonomy and the freedom to choose its own path to economic development *and* access to advanced technology and overseas markets. It is playing a trade-off game in which the variables are never constant.

*Id.*

200. Picciotto, *supra* note 7, at 48. This is nonsense on stilts. Philosophers may wish to transform tax laws into a “link” between the state and citizen, but in practice tax laws are one part of the rules by which individuals and entities operate. Respect for the rule of law requires both the tax authority and taxed individual or entity to respect the rules as written, not as imagined.

competition on one margin for the entire contest. For example, while the United States has relatively high nominal marginal rates for its corporate income tax compared to the OECD average, it also has quite generous depreciation allowances such that the effective marginal tax rate for new equipment financed by equity in a 2007 U.S. Treasury study was found to be just 24 percent rather than the nominal rate of 39 percent.<sup>201</sup> We have little doubt that this biased equipment purchases toward the U.S. entity at the expense of entities in other OECD jurisdictions within multinational businesses. If rate competition is “unfair,” should not depreciation allowance competition be as well?

The first goal of the financial regulatory network must therefore be to enable collection of the “fair” amount of taxes by various governments. To accomplish this, the Control First solution is built on that deployed earlier in pursuit of the proceeds of drug deals and corruption: identifying and tracing beneficial owners and transactions. However, these are more difficult to accomplish in the context of taxes, in part because of the much larger set of transactions that must be monitored. Rather than focusing on individuals suspected of drug crimes and those whose behavior fits a profile of an individual involved in such crimes (e.g., depositing large amounts of cash regularly), a tax-focus expands the pool of suspicious behavior to everyone involved in a cross-border transaction.

A significant part of the history of income taxation across jurisdictions is related to efforts to minimize tax evasion by making it difficult to fail to report income. To attempt to ensure that taxpayers declare all of their income, jurisdictions typically require parties that make payments that may constitute income to the taxpayer to inform the tax authorities of such payments and, occasionally, to withhold estimated tax on those payments as well.<sup>202</sup> In fact, modern income taxes fundamentally depend on systems of third party reporting and withholding to ensure

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201. BANK, *supra* note 76, at 250-51.

202. Gordon, *Losing the War*, *supra* note 166, at 556-557, and sources cited. The withholding of estimated tax enhances administration and reduces costs to the government by allowing a pay as you earn system. Konraad van der Heeden, *The Pay-As-You-Earn-Tax on Wages*, in TAX LAW DESIGN AND DRAFTING 564, 564-567 (Victor Thuronyi ed. 2001). The basics of U.S. international tax rules can be found in RICHARD L. DOENBERG, INTERNATIONAL TAXATION IN A NUTSHELL (9th ed. 2013).

compliance.<sup>203</sup> Thus both Britain and the United States adopted withholding at the source for wage income as part of their imposition of broad-based income taxes.<sup>204</sup> More recently, the United States has extended reporting requirements for nonwage payments to individuals to ensure that such income does not go unreported.<sup>205</sup> For many years, Britain used a complex system of tax withholding on dividend and retained corporate income to ensure that individual taxpayers paid the appropriate personal income tax.<sup>206</sup> As tax revenues as a share of GDP have largely risen throughout the world between 1965 and 2000, and were up "sharply" in most OECD countries in that period,<sup>207</sup> demand for tax strategies to reduce tax bills has increased.<sup>208</sup>

However, such requirements to report and perhaps to withhold normally applied only to payors who were resident of the jurisdiction imposing the tax.<sup>209</sup> After all, the laws of Country A do not normally apply to the residents of Country B, so Country A could not require payors who are under the jurisdiction of Country B to send Country A's tax authority information. Residents of Country A who were keen on evading taxes could take advantage of this situation by accumulating income in Country B and not declaring it to Country A's tax authority. Successful evasion would work only if Country B did not tax the income either or taxed it at a

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203. Gordon, *On the Use and Abuse*, *supra* note 168, at 516-17, 519-21.

204. I.R.C. § 3402; Income Tax Act, 2007, pt. 15, c. 1.

205. I.R.C. § 6041-6050W.

206. J.A. KAY & MERVYN A. KING, *THE BRITISH TAX SYSTEM* (5th ed. 1990) (describing the imputation system used to tax corporate dividends in the UK from 1973). Although alien to Americans' current conception of corporate taxation, this is in accord with at least some tax theory. See Boadway, *supra* note 73, at 94 ("One role of the corporations tax is to act as a backstop or withholding device for the individual tax"; to the extent it serves this function "such withholding should be recognized by providing a credit against individual taxes when these taxes are eventually paid on corporate source income."); *Id.* at 107 (describing how corporate tax functions as a withholding tax); Albi, *supra* note 7, at 131 ("The withholding function of [corporate income taxes], acting as a backstop to personal taxation, makes sense in the case of resident and non-resident shareholders, particularly if the latter are non-resident in name only."). See also Boadway, *supra* note 73, at 45 (discussing design of a corporate tax for this purpose).

207. Tanzi, *supra* note 154, at 12-14. The OECD total rose from 24.2% of GDP in 1965 (with a low of 10.6 in Turkey) to 36.1% in 2000 (with a low of 18.5% in Mexico). *Id.* at 13. (From 2000 to 2007, tax revenue as a percentage of GDP fell in 24 of 30 OECD countries.) *Id.* at 14-15.

208. Freyer & Morriss, *supra* note 8, at 21-24.

209. *Id.* at 520-21.

lower rate. Because the income tax is generally a residence-based system, Country B might not tax the income if the taxpayer declares herself or himself not to be a resident of Country B. Also, and more simply, evasion would work if Country B did not have an income tax at all.<sup>210</sup> The recent “scandal” involving Jérôme Cahuzac, who resigned as the Socialist Party’s Budget Minister in France, involved just this type of issue: M. Cahuzac had undeclared bank accounts in Switzerland and Singapore, which he may have used to evade French taxes on income paid directly to that account.<sup>211</sup> Of course, if the financial institutions in Country B discovered which of its customers were actually residents of Country A, and then reported to the tax authorities of Country A all financial information on those customers, then Country A could ensure that its residents did not commit tax evasion by failing to declare that income.

This is exactly what the G-7, the OECD, the United States, and the European Union have been advocating for some time,<sup>212</sup> and the framework, which has recently been adopted as policy by the Group of 20.<sup>213</sup> Previously larger, mostly onshore jurisdictions that depend on the income tax had pressed low or no income tax jurisdictions only to provide information on particular accounts when the taxing jurisdiction believed that one of its residents was committing tax evasion by receiving undeclared income in the low or no tax jurisdiction.<sup>214</sup> Although no offshore center or other jurisdictions with low or no income tax would ever need to request such information from high tax jurisdictions, nearly all have signed tax

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210. In part to prevent such evasion, the international tax system had long included a provision that payments that typically represented income paid by residents to nonresidents include a gross withholding tax. So, if the taxpayer in the above example opened an account at a bank in Country B, any payments to that account from Country A that typically represent income would be subject to a gross tax of 30%. However, many countries, including the United States, have over time exempted many types of transnational payments including, for example, bank interest and portfolio bond interest, from withholding taxes as a way of reducing interest costs to US borrowers. In other cases, bilateral income tax conventions reduced or eliminated gross withholding taxes on other types of payments.

211. Gérard Davet, Fabrice Lhomme & Simon Piel, *La justice enquête sur la banque Reyl & Cie* [Justice investigation into the bank Reyl & Cie], LE MONDE, May 14, 2013, [http://abonnes.lemonde.fr/politique/article/2013/06/14/fraude-fiscale-la-justice-en-quete-sur-la-banque-reyl-cie\\_3430212\\_823448.html](http://abonnes.lemonde.fr/politique/article/2013/06/14/fraude-fiscale-la-justice-en-quete-sur-la-banque-reyl-cie_3430212_823448.html).

212. Morriss & Moberg, *supra* note 26, at 44–47.

213. *Tax Annex to the Saint Petersburg G20 Leaders' Declaration* (Sept. 6, 2013), available at <http://www.g20.org/news/20130906/782776427.html>.

214. Gordon, *On the Use and Abuse*, *supra* note 168, at 515–19.



information exchange agreements with onshore jurisdictions.<sup>215</sup> Given the disparity in benefits, such agreements have been signed under pressure from onshore jurisdictions, organized in part through the OECD's two initiatives, the Harmful Tax Practices initiative and the Global Forum on Taxation, later renamed the Global Forum on Transparency and Exchange of Information,<sup>216</sup> and the European Union's Code of Conduct Group on Harmful Tax Practices.<sup>217</sup>

However, realizing that this did not *uncover* tax evasion but only facilitated prosecution of otherwise identified instances of tax evasion, these high tax jurisdictions are now seeking to require that financial institutions in other jurisdictions routinely report to the high tax jurisdictions details of the financial transactions of the residents of high tax countries when these transactions occur outside the high tax countries. In other words, the high tax countries wish to treat the financial institutions of low or no tax countries as if they are under the jurisdiction of the high tax countries. For example, starting in January 2014, the European Union's Council Directive on Administrative Cooperation in the Field of Taxation will do this for members with respect to wages, director's fees, and income from life insurance products, pensions, and immovable property.<sup>218</sup>

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215. *Exchange Of Tax Information Agreements*, OECD (Oct. 28, 2013) <http://www.oecd.org/tax/transparency/exchangeoftaxinformationagreements.htm>; OECD, *Convention on Mutual Administrative Assistance on Tax Matters*, <http://www.oecd.org/tax/exchange-of-taxinformation/conventiononmutualadministrativeassistanceintaxmatters.htm>.

216. Gordon, *On the Use and Abuse*, *supra* note 168, at 523–40.

217. *Harmful Tax Competition*, EUROPEAN COMMISSION (Oct. 28, 2013) [http://ec.europa.eu/taxation\\_customs/taxation/company\\_tax/harmful\\_tax\\_practices/](http://ec.europa.eu/taxation_customs/taxation/company_tax/harmful_tax_practices/).

218. In addition, they must also provide information when one E.U. country has reason to suppose that there may be a loss of tax in the other E.U. country; a person liable to tax obtains a reduction in, or an exemption from, tax in one E.U. country which would give rise to an increase in tax or to liability to tax in the other E.U. country; business dealings between two persons liable to tax in different E.U. countries are conducted through one or more countries in such a way that a saving in tax may result in either or both of the E.U. countries; the competent authority of one E.U. country has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises; information forwarded to one E.U. country by another E.U. country's competent authority has enabled information to be obtained which may be relevant in assessing liability to tax in the latter E.U. country. *Administrative Cooperation in the Field of Taxation*, Council Directive 2011/16/EU (15 Feb. 2011), *available at* [http://europa.eu/legislation\\_summaries/taxation/fi0006\\_en.htm](http://europa.eu/legislation_summaries/taxation/fi0006_en.htm).

Perhaps the most extensive (and intrusive) expansion of transnational reporting is the U.S. Foreign Account Tax Compliance Act (FATCA). FATCA requires foreign financial institutions to identify to the United States their U.S. account holders and to disclose their names and addresses, and the accounts' balances, receipts, and withdrawals.<sup>219</sup> Failure to do so would result in the United States applying a gross withholding tax of 30 percent on *all* payments of gross income to those financial institutions.<sup>220</sup> And, to uncover exactly who is a resident of the high tax country, foreign financial institutions will need to determine if U.S. residents are actually beneficial owners of arrangements with accounts in those countries.<sup>221</sup> In spite of such burdensome and expensive requirements, many low or no tax offshore centers have reached agreements or are expected to reach agreements with the United States to avoid the sanctions, including the Cayman Islands, Guernsey, Jersey, The Isle of Man, Singapore, and Switzerland.<sup>222</sup> European nations are creating their own "son-of-FATCA" laws to require similar efforts.<sup>223</sup>

In other words, high tax countries are forcing all jurisdictions, including those who do not have significant income taxation as a matter of policy, to serve as unpaid income tax law enforcement officers of the high tax countries, and even if the country does not report on the financial transactions of its *own* residents, typically

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219. 26 U.S.C. §§ 1471-1474.

220. 26 U.S.C. § 1441.

221. For this reason, FATCA requires foreign financial institutions to determine if a client has a "substantial U.S. owner." This means, in the case of any corporation, any specified U.S. person that owns, directly or indirectly, more than 10% of the corporation's stock (by vote or value). For any partnership, it means any specified U.S. person that owns, directly or indirectly, more than 10% of the profits interests or capital interests in the partnership. For a trust, it means a specified U.S. person treated as an owner of any portion of the trust under the grantor trust rules and any specified U.S. person that holds, directly or indirectly, more than 10% of the beneficial interests of the trust. *Id.*

222. Resource Center, Foreign Account Tax Compliance Act, UNITED STATES TREASURY, available at <http://www.treasury.gov/resource-center/tax-policy/treaties/Pages/FATCA.aspx> (last visited on Oct. 29, 2013).

223. Salman Shaheen, *UK to impose son of FATCA on Crown Dependencies, despite government's denials*, INT'L TAX REV., (Nov. 23, 2012), available at <http://www.internationaltaxreview.com/Article/3121964/EXCLUSIVE-UK-to-impose-son-of-FATCA-on-Crown-Dependencies-despite-governments-denials.html?LS=EM> S751719; Sanford Miller, *Son of FATCA-Swiss/U.K. Agree on Information Exchange*, JDSUPRA LAW NEWS, (Mar. 25, 2013), available at <http://www.jdsupra.com/legalnews/son-of-fatca-swissuk-agree-on-infor-96287/>.

because it has no income tax to enforce. An alternative, of course, would be for the high tax countries to provide their own tax authorities more resources, but this, of course, would cost them money. The high tax jurisdictions, not surprisingly, believe that it is better to require foreigners to provide them free tax administration services. This, even though the vast majority of tax cheating in high tax countries like the United States is done strictly domestically.<sup>224</sup> Nevertheless, *nearly all offshore and other low or no tax jurisdictions are complying*. They have little choice, since their economies are dependent on access to the larger onshore economies.

A further issue involves tax avoidance through transfer pricing. The international system of allocating the profits of transnational companies among different jurisdictions for purposes of income taxation evolved during the 1920s, primarily under the auspices of the League of Nations (and since the end of the Second World War, the OECD).<sup>225</sup> In essence, the system began with the assumption that each country should be permitted to tax the income of companies that arose within that country—in effect, to become “silent partners” with a share equal to the income tax rate.<sup>226</sup> The problem with such a system was that many companies were transnational, with either branches of the same company or separate companies operating as subsidiaries of a parent company located in different countries. Creating vertically integrated firms is one way that firms cope with the risks of international operations.<sup>227</sup>

Due to the fact that these groups of branches and subsidiaries operated as a single, integrated whole, they did not need to keep track of goods, services, and capital assets as they moved among branches or from one company to another. How, then, to allocate

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224. See Richard Cebula & Edgar L. Feige, *America's Underground Economy: Measuring the Size, Growth and Determinants of Income Tax Evasion in the U.S.* (University of Wisconsin, forthcoming 2011), available at <http://www.ssc.wisc.edu/econ/archive/wp2011-1.pdf> and sources cited.

225. Michael Graetz & Michael O'Hear, *The "Original Intent" of U.S. International Taxation*, 51 DUKE L.J. 1021 (1997).

226. It has long been argued that levying an income tax on companies separately from their human owners makes little economic sense, other than as a withholding tax on income to be distributed later to those human owners. See generally Graeme S. Cooper & Richard Gordon, *Taxation of Enterprises and Their Owners in TAX LAW DESIGN AND DRAFTING* (Victor Thuronyi ed. 2001), and sources cited.

227. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 71. Similarly, various intangibles such as “investments in technology, marketing and skills of organization” play important roles in NFP structures. *Id.* at 75.

taxable income among different jurisdictions? The solution was, in effect, to pretend that the economic activity by the single, integrated group of branches and companies was divided into independent companies, one for each jurisdiction in which the integrated whole operated. Each “separate” company would then be required to keep separate books of account, calculate its “separate” earnings, and report these to each jurisdiction. The only way to accomplish this, however, was for the integrated whole to invent prices for the goods, services, and capital assets that were transferred between each “separate” entity.

However, to calculate an accurate allocation of income among each “separate” entity, it would be necessary to compute these ‘transfer prices’ based on the prices that would have applied had the parties not been related, i.e., market-determined or “arm’s length” prices.<sup>228</sup> As there was no business reason for the integrated group to keep records of intra-group transfers, the group was compelled by taxation authorities to create them. In those cases where goods, services, or assets were transferred to persons outside the group this was easy. But in other cases, often the majority of instances (at least with respect to value) there were no such arm’s length prices available, requiring companies to find “comparable” transactions between companies that are not subject to the same control, and to make adjustments to those comparable transactions. As Michael Durst, one of the world’s foremost authorities on the issue, has put it, “[t]he basic tenet of arm’s-length transfer pricing—the availability of ‘uncontrolled comparables’ for transactions between commonly controlled parties—is based on a fundamental misunderstanding of practical economics.”<sup>229</sup> Professor Stephen Shay, formerly Deputy Assistant Secretary for International Tax Affairs at the U.S. Treasury Department and another of the world’s foremost experts on transfer pricing, recently noted with respect to a particularly important transfer pricing rules, the so-called “cost-sharing rule,” that

the application of theory and models in the messiness of the real

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228. “[A]n antiquated tax enforcement device called the ‘arms-length’ or ‘separate accounting’ method . . . .” Jonathan Rowe, *Unitary Method Curbs Tax Shenanigans: An Alternative To Arm’s Length*, MULTINATIONAL MONITOR (1980), available at <http://www.multinationalmonitor.org/hyper/issues/1980/09/rowe.html>.

229. Michael Durst, *The Two Worlds of Transfer Pricing Policymaking*, TAX NOTES 443 (Jan. 4, 2011).

world can lead to unintended or unanticipated results. As demonstrated by the repeated efforts to strengthen the cost sharing regulations and the continued evidence of income shifting to lower tax countries, the application of cost sharing in the context of the international taxation has proven to be highly problematic. This is in part because assumptions necessary for the theory of cost sharing to be valid, including that all contributions are fully accounted for, are nearly impossible to control in a real world setting<sup>230</sup>

Creating such prices for the taxation authorities became an onerous and expensive process, one that has become even more onerous and expensive as the value of *sui generis* intellectual property<sup>231</sup> has increased over time.<sup>232</sup>

To make matters more complicated, such groups of companies often operate in countries with varying rates of income tax or no income tax at all. In such cases, international groups have a clear incentive to allocate as much of the group's total income in member companies located in low or no tax countries.<sup>233</sup> The way to do so would be to err on the side of overstating deductible costs in companies located in high tax countries, with a correlative overstatement of income in companies located in low or no tax jurisdictions, when inventing transfer prices. Such incentives would obviously work more effectively on the taxpayer's behalf if one or more constituents of the group were located in a low or no tax

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230. Testimony of Stephen E. Shay Before the U.S. Senate Permanent Subcommittee on Investigations Of the Committee on Homeland Security and Governmental Affairs Hearing on Offshore Profit Shifting and the Internal Revenue Code, (May 21, 2013), at 6, *available at* [www.finance.senate.gov/imo/media/doc/062608sctest.pdf](http://www.finance.senate.gov/imo/media/doc/062608sctest.pdf).

231. *Id.* at 7 ("The difficulties with administering transfer pricing rules in relation to a sophisticated multinational group are compounded where comparable third-party transactions are unavailable or inexact, as is the case with respect to most high-value intangible property, and by the flexibility afforded a multinational corporate group in planning and executing its global legal and pricing structure to minimize tax.").

232. OECD, DEALING EFFECTIVELY WITH THE CHALLENGES OF TRANSFER PRICING 10 (2012), *available at* [http://www.oecd-ilibrary.org/taxation/dealing-effectively-with-the-challenges-of-transfer-pricing\\_9789264169463-en](http://www.oecd-ilibrary.org/taxation/dealing-effectively-with-the-challenges-of-transfer-pricing_9789264169463-en) ("[T]he resolution of transfer pricing disputes tends to be resource intensive for both [multi-national enterprises] and tax administrations.").

233. JANE G. GRAVELLE, Cong. Research Serv., R40623, TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION 9-10 (2013), *available at* <http://www.fas.org/sgp/crs/misc/R40623.pdf>; OECD, *Addressing Base Erosion and Profit Shifting* 33-37 (2013), *available at* <http://www.oecd.org/ctp/beps.htm>.

jurisdiction. On the other hand, taxation authorities from high tax countries have exactly the opposite incentive: to understate deductible costs in companies located in their countries when auditing taxpayers transfer prices.<sup>234</sup>

Moreover, while, at least in theory, economic rates of return are equalized in the long run across firms, the transfer pricing rules use *accounting* rates of return rather than *economic* rates of return, and these “would not be equalized even in competitive markets, poised in long-run equilibrium, much less in the imperfectly competitive markets in various states of disequilibrium that are the norm.”<sup>235</sup> Reliance on accounting data has important consequences for evaluations of transfer prices:

1. “Tax authorities in different jurisdictions are likely to allocate individual multinational firms’ consolidated income across countries in different ways.”
2. “Individual multinational corporations cannot accurately anticipate their country-specific tax liability in the absence of an Advanced Pricing Agreement [with tax authorities].”
3. “The current transfer pricing regime produces inequitable results.”
4. “Multinational and domestic firms are not treated uniformly for tax purposes.”<sup>236</sup>

In short, “a tested party’s tax liability under the [U.S. or OECD methods] is entirely dependent on the particular profit level indicator chosen and the specific unaffiliated companies included in one’s firm sample.”<sup>237</sup>

If there ever was a Control First reporting requirement with high cost and little chance of success, it would be the world’s transfer pricing regime. The OECD has provided, and continues to

234. *Id.*

235. ELIZABETH KING, *TRANSFER PRICING AND CORPORATE TAXATION* 7 (2010). As King notes, “there is no reasonable basis for assuming that one firm will earn the same accounting rate of return as a similarly situated competitor.” *Id.* To take just one example of why this is so, note that the book value of assets—a key component of the accounting rate of return—will be based on the accounting conventions followed by each company and so even identical assets may be recorded differently. Moreover, the accounting rates of return will be heavily influenced by the price paid for each asset (which will vary over time) and the extent to which the asset has been written off. *Id.* at 16.

236. *Id.* at 8–9.

237. *Id.* at 17. These problems exist for other methods as well. *See id.* at 17–41.

provide, hundreds of pages of guidance on how to estimate arm's length prices,<sup>238</sup> while individual higher tax jurisdictions have created their own libraries of regulations.<sup>239</sup> But ultimately, it is essentially impossible for private sector actors to invent accurate arm's length prices where there has been no arm's length bargaining. The same is true for tax authorities. While this truth has been obvious to both practitioners and scholars for at least 30 years, the OECD and higher tax countries have continued to reaffirm the arm's length standard.<sup>240</sup> Once again, the Control First impulse has turned private sector actors into unpaid adjuncts of governments, in this case by requiring them to invent arm's length prices where no market for those transactions actually exists. As with other Control First impulses, these controls add significantly to costs of doing business. In addition, Control First critics attack the private sector for not voluntarily guessing at transfer prices that result in transferring more profits to governments rather than less. Indeed, the OECD continues to argue in favor of more, and earlier, mandatory transparency and disclosure by taxpayers, without discussing the additional costs such disclosure might entail.<sup>241</sup>

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238. OECD, *TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS* (2010), available at <http://www.oecd.org/ctp/transfer-pricing/transfer-pricing-guidelines.htm>.

239. See, e.g., Treas. Reg. § 1.482-1 to 1.482-9.

240. In 1980, Jonathan Rowe described an "antiquated tax enforcement device called the 'arms-length' or 'separate accounting' method." Jonathan Rowe, *Unitary Method Cuts Tax Shenanigans: An Alternative To Arms-Length*, MULTINATIONAL MONITOR (1980), available at <http://www.multinationalmonitor.org/hyper/issues/1980/09/rowe.html>. Since then scholars have continued to attack attempts to implement arm's length pricing as a fool's errand. See, e.g. Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (Feb. 17, 1986), at 625; Reuven S. Avi-Yonah, *The Rise and Fall of Arm's-Length: A Study in the Evolution of U.S. International Taxation*, 15 VA. TAX REV. 89 (1995); and Durst and Robert E. Culbertson, *Clearing Away the Sand: Retrospective Methods and Prospective Documentation in Transfer Pricing Today*, 57 TAX L. REV. 37 (2003). In 2007, Reuven Avi-Yonah, one of the very best international tax academics, concluded simply that the current arm's length standard is "incompatible with today's global economy." Reuven Avi-Yonah & Kimberly Clausing, *Reforming Corporate Taxation in a Global Economy: A Proposal to Adopt Formulary Apportionment*, The Brookings Institution (2007), available at [http://www.brookings.edu/~media/research/files/papers/2007/6/corporatetaxes%20clausing/200706clausing\\_aviyonah](http://www.brookings.edu/~media/research/files/papers/2007/6/corporatetaxes%20clausing/200706clausing_aviyonah).

241. OECD, *TACKLING AGGRESSIVE TAX PLANNING THROUGH IMPROVED TRANSPARENCY AND DISCLOSURE: REPORT ON DISCLOSURE INITIATIVES* (2011), available at <http://www.oecd.org/ctp/exchange-of-tax-information/48322860.pdf>; OECD, *MINISTERIAL DECLARATION ON BASE EROSION AND PROFIT SHIFTING* (May 29, 2013)

Given the impracticability of creating a system of accurately allocating income among related members of a group through arm's length-transfer pricing, different alternatives that are far simpler to apply have been proposed. However, these systems either are fundamentally inaccurate (e.g., factor apportionment, where income is allocated based on relatively arbitrary formulas based on the location of factors such as sales, work force, and real property)<sup>242</sup> or deviate substantially from an income tax (e.g., the "destination" system proposed by members of the Oxford University Center for Business Taxation),<sup>243</sup> and none is likely to be implemented any time soon.<sup>244</sup>

In other words, the world's wealthiest and most powerful governments have created and persevered with a system to allocate transnational income that cannot work, but that they nevertheless fruitlessly try to implement by adding more and more costs to both private and public sectors. However, a fundamentally more radical "solution" has been proposed by governments of high tax countries that would at least eliminate the incentive for taxpayers to err on the side of higher prices paid by constituent members of the group located in their high tax jurisdictions, though it would not make it any easier for taxpayers or tax administrations to invent transfer prices. Conveniently, it would also eliminate the general incentive for businesses to locate in lower tax jurisdictions. The solution is to force all low or no income tax jurisdictions to adopt relatively high corporate income taxes. While so far largely ineffective, the efforts of the E.U., and many of the constituent member countries, to fight what they see as unfair tax competition by forcing low tax countries to raise their effective rates continues. The clamor over the recent bailout of Ireland (in which many EU members demanded that Ireland raise its corporate rates in exchange for credit support) and over the use of Irish subsidiaries by Apple and other companies suggest that these efforts are far from over.<sup>245</sup> A victory would

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available at <http://www.oecd.org/mcm/C-MIN%282013%2922-FINAL-ENG.pdf>.

242. GRAVELLE, *supra* note 233 at 26.

243. Michael Devereux, *How we can make global companies pay their fair share of tax*, FIN. TIMES 11, (May 23, 2013). At least internationally, U.S. states use a factor apportionment system. Avi-Yonah & Clausing, *Reforming Corporate Taxation*, *supra* note 240, at 13.

244. GRAVELLE, *supra* note 233, at 24-26.

245. John Murray Brown, *Ireland defends low corporate tax rate*, FIN. TIMES, Apr. 15, 2011, <http://www.ft.com/cms/s/0/e90525f2-66a1-11e0-ac4d-00144feab49a.html>



represent the epitome of the Control First view: controlling not only the collection and reporting of financial information, but tax systems—and tax rates—themselves.<sup>246</sup>

Is this wise or fair? Many offshore centers chose not to have income taxes, perhaps because they made little sense from an administrative or economic perspective.<sup>247</sup> For example, a consumption tax (such as sales tax or a value-added tax (VAT)) does not depend on tax reporting by those earning income but rather by those selling covered goods and services. The expansion of VATs is “[t]he most important tax development of the last half-century.”<sup>248</sup> Collection of consumption taxes poses a different set of challenges to tax authorities, e.g., cash purchases may be made without being recorded for tax purposes, and so made without collecting the tax.<sup>249</sup>

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246. Another tax evasion issue involves the use of offshore companies to generate fictitious losses. Because these are instances where the taxpayer must reveal the existence of the offshore company, the tax authorities can require the taxpayer to provide further proof of the losses. More traditional exchange of information agreements can be used to help confirm or deny the reality of such losses.

247. Gordon, *On the Use and Abuse*, *supra* note 168, at 521; *See, e.g.*, Boadway, *supra* note 73, at 119 (“Taken together, these arguments [summarized by the author] based on administrative ease, efficiency, and equity conspire against comprehensive income as an ideal form of taxation.”). Consumption taxes are also superior to income taxes because they tax “present and future consumption at the same rate, while income and scheduler (dual) taxation tax future consumption at a higher rate than present consumption.” *See, e.g., id.* at 118. They also avoid “many of the problems of income taxation” by avoiding calculating capital income and indexing capital gains. *Id.* at 120. *See also* Levin & Ritter, *supra* note 77, at 235 (“Developing countries, with less complex tax systems in place, may therefore perhaps be bolder. There is no need for developing countries to fall into the same traps of tax system design” and so they may be able to adopt consumption-based systems.).

248. Jorge Martinez-Vasquez & Richard M. Bird, *Value-Added Tax: Onward and Upward?*, in ELGAR GUIDE, *supra* note 7, at 218, 218.

249. *See generally*, Martinez-Vasquez & Bird, *Id.* at 255–58 (discussing problems of evasion of VATs); Michael Keen & Stephen Smith, *VAT Fraud and Evasion: What Do We Know, and What Can be Done?*, 59 NAT. TAX J. 861, 866–67 (Dec 2006) (sales off the books is only one form of avoidance on VATs; under-reporting sales, failing to register at compulsory levels of turnover, misclassifying commodities for different rates, and engineering bankruptcy before payment are other forms); Nikolaos T. Artavanis et al., *Tax Evasion Across Industries: Soft Credit Evidence from Greece* (Univ. of Chi. Booth Sch. of Bus., Fama-Miller Ctr. for Research in Fin., Paper No. 12-25, 2012), available at SSRN: <http://ssrn.com/abstract=2109500>; G. Agapetos, *VAT Evasion: Overview of the Greek Experience*, 17 J. MODERN GREEK STUD. 151 (1999); Simon Wilson, *How carousel fraud is putting the VAT system in a spin*, MONEYWEEK (Aug. 31, 2006), <http://moneyweek.com/how-carousel-fraud-is-putting-the-vat->

Applying consumption taxes to transactions across borders also pose problems in deciding which jurisdiction is entitled to tax the transaction. Internet transactions posed such a problem in the United States, with internet retailers without a physical presence in a particular state not collecting sales tax on shipments to that state's residents.<sup>250</sup> Efforts to persuade consumers to report and pay taxes on out-of-state purchases generally failed.<sup>251</sup> In some instances, specific types of consumption and excise taxes are avoided by shifting transactions to different jurisdictions, as with tobacco sales on Native American reservations relative to sales in stores in states where tobacco taxes apply and bootlegging.<sup>252</sup> Similarly, locating transactions in low tax jurisdictions can defeat efforts to apply taxes based on physical presence.

All systems of taxation thus present challenges to tax authorities in ensuring that all relevant transactions or income are taxed. Each type of tax presents different challenges, however. For example, efforts to tax at progressive rates based on total income require a consolidated tax return that reports the entire income of the taxpayer. Hong Kong uses a schedule-based income tax system that precludes progressive rates because taxpayers report different forms of income on different schedules to different tax authorities.<sup>253</sup> Without a total income, it becomes impossible to tax on a

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system-in-a-spin/.

250. Donald Bruce, William Fox & Matthew Murray, *To Tax or Not to Tax? The Case of Electronic Commerce*, 21 CONTEMP. ECON. POL. 25, 25-26 (Jan. 2003), available at <http://web.utk.edu/~dbruce/cep03.pdf> (use tax collection generally relies on voluntary compliance); Priyanka Meharia, *e-Commerce and Taxation: Past, Present and Future*, 11 IUP J. ACCOUNTING RES. & AUDIT PRAC. 25 (2012) (discussing efforts to tax ecommerce).

251. STEVEN MAGUIRE, CONG. RESEARCH SERV., R41853, STATE TAXATION OF INTERNET TRANSACTIONS 1 (May 2013), available at <http://www.fas.org/sgp/crs/misc/R41853.pdf> (consumers are required to remit use taxes to their taxing jurisdiction for the use of the product purchased. Compliance with this requirement, however, is quite low).

252. See Philip DeCicca, Donald Kenkel & Feng Liu, *Reservation Prices: An Economic Analysis of Cigarette Purchases on Indian Reservations* 1 (May 2010) (as of 2010, New York did not collect taxes on cigarettes sold on Indian reservations. The sales on these cigarettes appear substantial—a consumption rate 20 times higher than the average New York resident, if consumed only by tax immune citizens. This allows an inference of sale to non-Native Americans.). Kusum Singh, *Cross-Border Shopping: Implications for State Fiscal Competition in Multiple Tax Instruments* (Univ. of Ky., 2011), available at [http://uknowledge.uky.edu/gradschool\\_diss/155](http://uknowledge.uky.edu/gradschool_diss/155).

253. Littlewood, *supra* note 111, at 385-86.

progressive rate schedule.<sup>254</sup> Is this a feature (as the Anglo and Chinese business communities thought when the system was adopted after World War II) or a bug?

There are policy arguments for and against particular forms of taxation. Moreover, "tax policies have been increasingly used to promote non-revenue objectives."<sup>255</sup> To a considerable extent, the debate over the appropriate form and level of taxation can be resolved only by resort to political preferences; without an agreement on the purpose of the tax system (for example, redistribution or non-distortionary funding of public goods) there can be no agreement on the "best" system. With respect to the debate about the impact of Jurisdiction A's tax system on Jurisdiction B's tax system, arguments that Jurisdiction A is engaged in "unfair" tax competition assume the outcome by failing to recognize that different jurisdictions simply make different policy choices.<sup>256</sup> Moreover, efforts to skew the debate by labeling jurisdictions that rely primarily or entirely on indirect taxation as "zero tax" or "low tax" jurisdictions are misleading. Obviously, even a jurisdiction relying entirely on indirect taxes is not a "zero tax" jurisdiction, just a zero income tax jurisdiction<sup>257</sup>

#### 4. Redistribution

Many Control First framework proponents want to make use of control over money flows to redistribute income and wealth. For example, Henry, author of TJN's *The Price of Offshore Revisited*, argued in his 2003 book *The Blood Bankers: Tales from the Underground Global Economy* that "[r]ising inequality is an important anomaly for

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254. *Id.* at 386.

255. Tanzi, *supra* note 154, at 11; Levin & Ritter, *supra* note 77, at 198 ("Numerous special regimes and deductions apply to financial investments, as encouraging these investments is often regarded as an important policy objective to encourage risk capital or to stimulate pension savings, for example.").

256. The structure of an economy affects the design of the tax system. See Bird, *supra* note 24, at 417 ("tax design is ... strongly influenced by economic structure."). Moreover, as Winer et al., note, "there is no reason to limit international competition to that over taxation, since there are other types of policy instruments that can often serve as good substitutes." Stanley L. Winer, Lawrence W. Kenny, & Walter Hettich, *Political Regimes, Institutions, and the Nature of Tax Systems*, in ELGAR GUIDE, *supra* note 7, at 376, 402.

257. Jorge Martinez-Vasquez & Bird, *Direct versus indirect taxation: trends, theory, and economic significance*, in ELGAR GUIDE, *supra* note 7, at 37, 54 (noting that smaller population countries tend to rely more on indirect taxes because they have a more mobile tax base).

conventional economics to explain, because it predicts that competitive markets and free trade should lead to the convergence of global income and wealth levels over time”<sup>258</sup> Similarly, in *The Price of Offshore Revisited*, he concludes the report with an emphasis on inequality: “all of our conventional measures of inequality sharply understate the levels of income and wealth at both the country and global level.”<sup>259</sup> Offshore wealth has an “astonishing” impact on inequality: “We have estimated, for example, that less than 100,000 people, .001% of the world’s population, now control over 30 percent of the world’s financial wealth.”<sup>260</sup> As a result, he concludes that active measures, including redistributive taxation, are necessary to address inequality.<sup>261</sup> Similarly, Control First proponents see collecting corporate taxes as a tool of redistribution, ignoring the need to justify such taxation “on grounds other than those of simple consistency with taxation of wage income” because of the implicit

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258. HENRY, BLOOD BANKERS, *supra* note 9, at xxi. This is nonsensical—economic theory makes no such prediction. In particular, Henry’s example of post-Soviet Russia (where he asserts “living standards have fallen farthest” while “inequality has increased the most”) illustrate the problems with such superficial claims. *Id.* Exploitation theorists like Henry focus on cherry-picked and misleading statistics. For example, Henry’s claims that inequality has risen “the most” in post-Soviet Russia certainly fails to take into account the inequality that existed in Soviet Russia in which the elites enjoyed access to goods, privileges, and services unavailable to ordinary Soviet citizens. See, e.g., MILTON AND ROSE FRIEDMAN, FREE TO CHOOSE 146–47 (“Russia [the Soviet Union] is a country of two nations: a small privileged upper class of bureaucrats, party officials, technicians; and a great mass of people living little better than their great-grandparents did. The upper class has access to special shops, schools and luxuries of all kinds; the masses are condemned to enjoy little more than the basic necessities.”). See also Abram Bergson, *Income Inequality under Soviet Socialism*, 22 J. ECON. LIT. 1051 (1984). However, even addressing only the post-Soviet experience of Russia, Henry’s analysis falls short by failing to account for the problematic nature of post-Soviet Russian governmental institutions. There is no basis for claiming that economic theory would predict an evolution toward equality between countries with and without developed legal institutions, for example.

259. Henry, *supra* note 4, at 40.

260. *Id.*

261. *Id.* at 42 (suggesting a “modest OECD-wide withholding tax on ‘anonymous assets under management’ in the top 50 banks, with the proceeds devoted to aid and climate change.”). Absent from TJN’s discussion of inequality is any appreciation for the complexity of the issues. For example, there is evidence that the burden of corporate taxation is borne by labor rather than capital (by reducing new savings and investment, leading to lower wages) and shareholders (due to “tax-induced managerial underperformance” and the inability to shift the tax on ‘old’ capital). Albi, *supra* note 7, at 131. This suggests corporate tax burdens may ultimately increase inequality.

double taxation inherent in corporate taxes.<sup>262</sup>

The ability of individuals and firms to move assets around the world constrains the ability of a government to redistribute income and wealth. Canadian millionaire Harry Oakes famously moved to the Bahamas in the 1930s, fleeing high levels of redistributive taxation.<sup>263</sup> In the United States, retirees leaving the Midwest for Florida found not only sunshine and warmer winters, but also avoided the higher estate taxes imposed in the states where they worked.<sup>264</sup> Control First proponents see such efforts as illegitimate and reject constraints imposed by markets on governments' ability to redistribute wealth.<sup>265</sup> Such constraints may be behind the trend away from comprehensive, progressive income taxes in recent years.<sup>266</sup> More generally, some argue that the evidence suggests not only that globalization has the effect that "all countries are becoming small open economies" but that they are also "forced to lower their reliance on direct taxes vis-à-vis indirect taxes."<sup>267</sup> However, this may not always be the case, especially in countries that have effective and efficient income tax administrations. For example, while the U.K. is one of the most open economies in the world, the share of total income tax paid by those who earn over

262. Honohan, *supra* note 42, at 9.

263. GEOFFREY BOCCA, *THE LIFE AND DEATH OF SIR HARRY OAKES* 82-83 (1959).

264. See generally Jeffrey A. Cooper, *Interstate Competition and State Death Taxes: A Modern Crisis in Historical Perspective*, 33 PEPP. L. REV. 835 (2006) (Florida's estate tax scheme created a national concern as early as 1925, leading to a national estate tax with state tax credits available.).

265. For example, TJN promotes "progressive and equitable taxation" as the ideal. See, *Tax Havens Cause Poverty*, TAX JUSTICE NETWORK (Oct. 28, 2013) [http://www.taxjustice.net/cms/front\\_content.php?idcatart=2&lang=1](http://www.taxjustice.net/cms/front_content.php?idcatart=2&lang=1). The current trend is towards dual income taxes with lower rates on capital income, in part as a response to international capital mobility. Albi, *supra* note 7, at 150. One reason for this is that high marginal rates "clearly induce a variety of changes in the behavior of taxpayers, with resulting economic costs. Tax-induced changes may include changes in hours worked and in labor force participation, the substitution of non-taxable for taxable consumption, changes in the timing of income realization, changes in the form of compensation (including incorporation), use of deferred compensation and other tax shelters, and increased evasion." Bird, *supra* note 24, at 426. Rather than recognizing that tax competition imposes limits on their preferred policies, TJN rages against the idea of competition.

266. Tanzi, *supra* note 154, at 25 (noting "gradual movement toward the scheduler income taxes that had been common in continental Europe in the early part of the last century. This movement has been in part forced by globalization and by tax competition.").

267. Jorge Martinez-Vasquez & Bird, *supra* note 257, at 57.

£150,000 has increased from 22.2 to 27.7 percent in the period from 2000 to 2013.<sup>268</sup> Not surprisingly, Richard Bird has concluded that “[a]n obvious reason why most developing countries reap little from either income or property taxes is their continued inability to administer such taxes effectively.”<sup>269</sup>

Again, the question is whether any government or a particular government has a “right” to tax those subject to its jurisdiction that requires other governments to act to insulate it from the forces of intergovernmental competition and the consequences of the laws and regulations adopted to enforce its tax policy choices. The ability to raise tax rates, as happened in OECD countries through at least 2000,<sup>270</sup> incentivizes tax avoidance measures by taxpayers. However, despite this, there is evidence that cutting corporate rates has not reduced tax revenue.<sup>271</sup> And, of course, there are constraints on tax design that require trading off competing goals that may affect revenue.<sup>272</sup> There are innumerable issues requiring tradeoffs involved in designing an actual tax system that go beyond the simplistic, one dimensional focus on a single aspect of tax equity used by Control First proponents. All tax policy makers face competing demands based on “the desire for increased revenue constrained by public resistance to taxes, the demand for more fair taxes, and the need for economic growth.”<sup>273</sup> Indeed, one scholar has concluded that “[t]he administrative problems of implementing a comprehensive income tax are nigh insuperable.”<sup>274</sup> Moreover, even among countries with broadly similar tax systems, the

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268. Matt Chorley, *Squeezing the Rich*, MAIL ONLINE <http://www.dailymail.co.uk/news/article-2451686/Top-1-earners-pay-THIRD-income-tax-year.html> (last visited on Oct. 28, 2013).

269. Bird, *supra* note 24, at 418.

270. Tanzi, *supra* note 154, at 12. Direct taxes account for an increasing share of total taxes in OECD countries. Martinez-Vasquez et al., *supra* note 257, at 40. This has a similar impact.

271. Tanzi, *supra* note 154, at 27; ALBI, *supra* note 7, at 137-38 (noting rising revenues while rates on corporate taxes fell from late 1980s to 2008 in Europe and the OECD generally).

272. See, e.g., Boadway, *supra* note 73, at 103 (describing constraints imposed by differences in elasticity of the supplies of capital and wage income and by the possibility of tax evasion and restraints on possible penalties); STEINMO, *supra* note 23, at 3 (“Any tax system embraces a complex mix of competing goals, ambitions, and considerations.”).

273. *Id.* at 21.

274. See, e.g., Boadway, *supra* note 73, at 117.

incidence and structure of particular taxes may vary considerably across countries.<sup>275</sup> If one government makes particular choices, there is no generally recognized principle of international law that requires other governments to accommodate those choices in forming their tax policy (or any other policy).<sup>276</sup>

Further, tax scholar Vito Tanzi noted that "[t]here is no theory that can tell us what should be the optimal level of taxation for a country. That level would depend on (1) how well governments use the tax revenue; (2) how good are the tax laws used to collect the revenue; (3) how good is the tax administration; and (4) how citizens react to the inevitable disincentive effects that high tax rates generate."<sup>277</sup> Moreover, tax structures depend on details of political arrangements.<sup>278</sup> These considerations are absent from the Control First literature. As we noted above, the current Control First initiatives also raise the question of who is to pay for these costs, as

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275. STEINMO, *supra* note 23, at 14.

276. As Steinmo notes, tax policy is no longer distinct from policy generally, as tax laws are "seen as powerful instruments of social policy" and not merely revenue measures. *Id.* at 59.

277. Tanzi, *supra* note 154, at 14-16. Bird puts it similarly:

The best tax system for any country is presumably one that reflects its economic structure, its capacity to administer taxes, its public service needs, and its access to such other sources of revenue as aid or oil. In addition, it must also take into account such nebulous but important factors as 'tax morale', 'tax culture', and, perhaps above all, the level of 'trust' existing between people and their government. Tax policy decisions are not made in a vacuum. Nor are tax systems implemented in one. The taxes that are adopted in a country and how they are administered are always and everywhere both path-dependent and context-specific. They reflect the outcomes of complex social and political interactions between different groups in society in an institutional context established by history and state administrative capacity.

Bird, *supra* note 24, at 423. Similarly, Honohan defines a tax system that is "good for the financial system" as one that meets three criteria: "It minimizes the distortions it imposes, for a given amount of revenue collected, especially by causing the formal financial sector to be bypassed through disintermediation to untaxed or differently taxed competitors. It is corrective of known distortions, such as those that result from imperfect and asymmetric information. Finally, it does not push tax collection from the sector beyond the point where marginal distorting costs exceed those elsewhere in the economy." Honohan, *supra* note 42, at 3.

278. Winer, Kenny, & Hettich, *supra* note 256, at 378-79 (noting roles of "differences in political transactions costs and the role and importance of veto players in a particular political setting."); *id.* at 393 (discussing degree to which differences between the United States and Canada in tax may be related to political structure).

many of these initiatives externalize the compliance costs on to governments, firms, and individuals without an interest in other governments' enforcement of particular tax policy choices.

### 5. Summary

The Control First framework is nearly a photographic negative of the Efficient Enterprises framework. Rather than focusing on gains from the movement of money, the primary issue is controlling the negative side effects of financial flows. These include any competitive pressure on states that constrain their political choices.<sup>279</sup> This includes political choices by even nondemocratic governments, for Control First proponents sometimes deny the need for protection of citizens against autocratic regimes or fail to distinguish between obligations owed to autocratic governments and those owed to democratic governments.<sup>280</sup> In addition, it is individuals and corporations with money who pose the threat rather than governments: they must be restrained to permit freer state action.

This implicitly assumes that all financial market constraints on governments are problematic. However, developed economies in which the standard of living of a large proportion of the public depends on the market economy "have powerful internal feedback mechanisms that prevent or limit demands that pose sustained threats to the viability of the productive sector." These are absent in many developing economies.<sup>281</sup>

The assumption that financial constraints are illegitimate accords governments, even those without democratic systems, a presumption of legitimacy. It is unclear whether even governments like Iraq under Saddam Hussein or Zimbabwe under Robert Mugabe lose this presumption.<sup>282</sup> Moreover, Control Firsters appear to reject the argument that even democratic governments may be

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279. These pressures go beyond tax competition. There is evidence that investors place lower values on firms from corrupt countries. See Lambsdorff, *supra* note 29, at 36.

280. See, e.g., Henry, *supra* note 4, at 25 ("it is very hard to defend 'tax enforcement at any price' when the tax collector is the Burmese junta, Gaddafi's Libya, or perhaps even the City of Chicago." However, TJN concludes that "most countries operate very, very far from this hypothetical 'tax compliance vs. freedom-and-prosperity margin.'").

281. Khan, *supra* note 187, at 228.

282. Henry, *supra* note 4, at 25 (dismissing such concerns).



constrained in beneficial ways by market pressures.<sup>283</sup>

However, Control First proponents selectively apply this presumption of legitimacy, according it only to the constrained jurisdictions' governments and rejecting it with respect to the jurisdictions whose policies create the constraints. Since even reasonable policies endorsed by democratic majorities of one jurisdiction may not be considered as such in another jurisdiction, this is problematic. More particularly, while the government of one jurisdiction may conclude that it is worth imposing significant financial transaction costs on its own residents to achieve some anticrime or tax evasion objective no matter how marginal, there is no reason to suppose that the governments of all other jurisdictions share the same conclusions.<sup>284</sup> While this is far more likely to be the case when the benefits of such additional transaction costs accrue to the residents of on-shore than offshore places, it may also be that different governments have reached different conclusions as to

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283. See, e.g., STOPFORD, STRANGE & HENLEY, *supra* note 11, at 101 ("Regulation can vary from laissez-faire to the oppressive and capricious."). Further, consent in a democratic regime may make income taxes more administratively feasible. See Winer, Kenny, & Hettich, *supra* note 256, at 383-85 (noting that democratic regimes rely more heavily on income taxation than authoritarian ones, and suggesting that consent makes a difference). The lack of consent in authoritarian regimes may account for some of the "looting" that occurs there.

Control First proponents have a ready answer to these points—it is the existence of a network of "secrecy jurisdictions" which facilitates the looting by corrupt government officials. In short, make it harder to hide the fruits of corruption and there will be less corruption. This argument has some appeal: if corruption is more costly, surely there will be less of it. However, the Control First arguments rarely engage in any cost-benefit analysis of the measures they seek to use to reduce corruption and put little weight on the need for the country where the looting is occurring to stop the initial theft, preferring to concentrate on the proceeds. International competition may constrain sovereignty in helpful ways. For example, political decision makers may want to be able to use domestic monetary and fiscal policies to promote full employment but be constrained by international pressures on their currencies. Whether that is a good thing or not depends on whether the analyst believes that governments make responsible choices in engaging in simulative monetary and fiscal policies. The long-standing consensus among economists that central bank independence is a key to restraining excessively inflationary policies suggests that this issue is at least open to question. Nonetheless, the key point is that in the Control First framework, finding evidence to support these claims is not a precondition to efforts to enhance control over international financial flows.

284. ALEXANDER ET AL. define legitimacy as "those subject to international regulatory standards have participated in some meaningful way in their development" and also suggest that regulatory measures require a measure of effectiveness and accountability as well. ALEXANDER ET AL., *supra* note 2, at 15.

whether to adhere more closely to the Efficient Enterprises view than the Control First view or vice versa. A more reasonable understanding of national sovereignty suggests that onshore jurisdictions should neither be able to order offshore jurisdictions to run up costs to the benefit of onshore places nor impose their views of appropriate trade-offs in economic policy.

Control First advocates have sometimes conceded that onshore jurisdictions have helped to create the legal framework in which offshore jurisdictions are able to provide opportunities for tax avoidance, but argue that the onshore jurisdictions “helped create a monster they could not properly control.”<sup>285</sup> Thus the dominant conceptualization of international finance is as a corrosive force in which “capital” or “capital markets” erode state sovereignty by imposing costs on the adoption of policies that impose costs on the owners of capital. Considerable resources exist in this zone outside of governmental control.<sup>286</sup> We now turn to the ways in which money “moves,” examining how the reality of finance fits with these two frameworks.

## II. The World’s Financial Plumbing

Today’s global economy involves a great deal of money “moving” from jurisdiction to jurisdiction, with the result that “[p]ayments systems are an integral part of an efficient modern economy.”<sup>287</sup> Not only do firms and people in one jurisdiction frequently buy things or services from firms and people in another, but “the growth of Eurocurrency markets, international syndication of loans, government loans and foreign direct investment” together with “[t]he dismantling of restrictions on financial flows across borders, the deregulation of financial institutions (sic) and

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285. Picciotto, *Legal Fiction*, *supra* note 7, at 8. There is little doubt that capital markets constrain government autonomy. See STOPFORD, STRANGE & HENLEY, *supra* note 11, at 6 (noting that it “is the world financial] system in which the firms are but one set of players and are increasingly recognized as such” that “have constrained” governments’ autonomy). The debate is over whether these constraints are either desirable or able to be removed.

286. For example, Ronen Palan argues that “[t]he growth of offshore finance is being driven to a significant extent by private banking” and that 20 % of the world’s private wealth is managed by private banks. Palan, *supra* note 7, at 23. The Tax Justice Network estimates that private offshore financial assets range from \$12.1 trillion to \$20 trillion, depending upon whether they use a 3.0 or 4.9 liquidity ratio. Henry, *supra* note 4, at 36.

287. MILLER & CAFAGGI, *supra* note 35, at 120.

international financial innovations" has "significantly" increased the movement of capital.<sup>288</sup> This globalized financial environment both offers opportunities to firms and individuals and introduces new risks with which each must cope.<sup>289</sup> In this section, we describe how the world's financial plumbing operates and the implications for both policy frameworks.

### A. *How Money 'Moves'*

The use of metaphors to explain unfamiliar or complex systems can both enlighten and confuse, and such is the case with the use of the metaphor "moving money." In reality, the modern bank-based payment system does not "move money," but rather transfers claims. When the Control Firsters describe "moving trillions of dollars through offshore centers," images of cash flowing through oil pipeline-like conduits through small islands on its way to a final destination do suggest unnecessary detours. Who would ever move anything that way, unless for some corrupt or nefarious purpose? But that is not what actually occurs. What does happen is that payors, in effect, chose to hire the legal regimes and management skills found in particular jurisdictions (often offshore centers) to ensure that their funds are safely and efficiently managed as the funds make their way to ultimately buying goods and services.

How does this work? Before the development of the bank-based payment system, to engage in commerce beyond barter governments, firms and individuals physically transferred specie from buyer to seller, or from investor to entrepreneur. Such transfers could be expensive and quite risky, with both cost and risk increasing with the distance the specie had to travel. The modern payment system developed to reduce expense and risk, thereby cutting transactions costs and allowing goods, services, and investment to flow more abundantly.<sup>290</sup> This was a significant step in the creation of the modern economy.<sup>291</sup> As a result, however,

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288. BEENHAKKER, *supra* note 30, at 1.

289. *Id.* at 2.

290. James McAndrew & William Roberds, *Payment Intermediation and the Origins of Banking*, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORTS 1-7, 12-13, 17-20 (1999), available at [http://app.ny.frb.org/research/staff\\_reports/sr85.pdf](http://app.ny.frb.org/research/staff_reports/sr85.pdf)

291. *Id.* at 17-20. ALEXANDER ET AL., describe this development as follows:

The objective of reducing risk in complex financial markets has led banks to use innovative financial instruments to diversify earnings among several countries so that, in any given year, an inadequate investment outcome in

since the creation of modern banking, nearly all of what we commonly refer to as “money” has no physical form and is really nothing more than a claim against a bank in the form of a deposit. The modern payment system, both nationally and internationally, is actually a system of adjusting claims by persons against their banks and among banks themselves rather than a system of “moving” money.<sup>292</sup> This is a critically important component to a modern economy.<sup>293</sup>

Assume, for example, that Janet wishes to buy a house from Bill, paying the entire purchase price without recourse to a loan. She could give Bill physical money in exchange for title to the house, but Bill would then face the problem of safeguarding a large amount of currency and/or transporting it to his bank. If Janet instead makes a payment to Bill via a check, debit card, or an online transfer through her account with Bank A, Bill no longer faces those problems. Janet’s “account” with Bank A, whether checking or savings, is actually a claim she has against the bank for the amount in her account. In other words, Janet is a creditor of Bank A to the amount of the account. By using a check, debit card, or an online transfer, Janet is instructing Bank A to transfer part of her claim to Bill. If she used a check, Bill could simply stop in at Bank A, present the check, and exchange it for cash. But if Bill is also part of the payment system, that would mean that he, too, would have an account at a bank, say, Bank B. Instead of cashing the check, he can receive the transfer of Janet’s claim against Bank A by adding to his claim against Bank B. As a practical matter, that means that (1) Bank A will adjust Janet’s claim against it downward by debiting her account by the amount of the transfer; (2) Bank A will credit Bank

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one country may be offset by a positive investment outcome in another country. This need to reduce risk by expanding cross-border financial services has also resulted in the establishment of complex organizations, known as financial conglomerates.

ALEXANDER ET AL., *supra* note 2, at 25–26.

292. Bank for International Settlements, Committee on Payment and Settlement Systems, *THE ROLE OF CENTRAL BANK MONEY IN PAYMENT SYSTEMS* 9–12 (2003), available at <http://www.bis.org/publ/cpss55.pdf>.

293. Ranald Michie, *The stock market and the corporate economy: a historical overview*, in *HANDBOOK OF RESEARCH ON STOCK MARKET GLOBALIZATION* 28, 29 (Geoffrey Poitras ed., 2012) (“The more complex and sophisticated the economy, the greater the need there is for a financial system that continually responds to the ebb and flow of credit and capital over both time and space and between individuals, institutions and businesses.”).

B's claim against it by the same amount, and (3) Bank B will credit Bill's claim against it by the same amount.<sup>294</sup> If Janet had wished only to transfer money from her account at Bank A to her account at Bank B without buying anything, the same process would be followed, except the claim transfer would be to her claim against Bank B.

The process of changing claims is typically implemented through a clearinghouse, often operated through a jurisdiction's central bank.<sup>295</sup> In fact, a national currency—the units transferred via changing claims and claimants—is itself a claim against the central bank that issued the currency. In effect, much of both Bank A and Bank B's assets are ultimately claims against the central bank that created the currency in the first place. It is this system of transferring claims among different banks, including central banks, which allows governments, firms, and individuals to engage in economic activity without the expense and risk of physically moving specie or currency. The development of the electronic payments system, by which claim transfer can be done electronically rather than moving paper checks around, has further reduced cost and risk.

The vast majority of contemporary international money movements do not involve the transfer of specie for the same reason that domestic movements do not: expense and risk of loss. They follow essentially the same patterns as domestic movements, only they involve banks located in different jurisdictions—i.e., transfers of claims from banks in one jurisdiction to banks in another. The international payment system allows governments, firms, and persons to conduct trade and investment across international borders (almost) as easily and inexpensively as does the domestic system. Moreover, when money “moves” by being reflected in accounts, it may move through a wide variety of channels. Different channels offer governments different degrees of control. Most jurisdictions impose restrictions on the physical movement of currency, for example. Thus when entering a jurisdiction, travelers are generally asked to declare “monetary instruments” in excess of the set amount (and FinCEN has proposed regulations to include

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294. This all happens quickly, but if timing matters, the order of the transactions is the reverse from how we have presented it.

295. *Id.* at 20–22.

prepaid cards in that definition).<sup>296</sup> As noted above, banks may clear transactions through a central clearing house.<sup>297</sup> But banks may also clear transactions internally, as they sometimes do to avoid paying clearinghouse fees. For example, when a merchant and a consumer who both bank with Citibank engage in a credit card transaction, Citibank may clear the transaction in-house rather than through MasterCard or Visa.<sup>298</sup> (Similarly, in-house transaction clearing may occur with “on-us” checks and wires). In addition, nonbank financial networks may clear transactions through exchanges of emails or other means. For example, the hawala remittance system used in South Asia and cell phone payments systems in Africa need not involve any entries in an account for the participants but instead often relies on offsetting transactions between entities in various jurisdictions.<sup>299</sup> While such transactions may be a relatively small portion of international movements of money, they may also include a disproportionate share of illegal transactions precisely because of the lack of account records.

Even in transactions that do involve account entries (as the vast majority among businesses by volume certainly do, because a record of transactions is essential to most business accounting efforts), the identification of the owner of accounts is not straightforward. In our simple example above, the money comes from an account owned by Janet and is deposited into an account owned by Bill. But perhaps Janet is acting on behalf of Tom (who may not want Bill to know who is buying his house because he believes Bill would charge a higher price if he knew that Tom was buying the property, or who may have acquired the funds through illegal activity and so

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296. See, e.g., 31 U.S.C. § 5316; FinCEN Form 105 *Report of International Transportation of Currency or Monetary Instruments*, available at [http://www.fincen.gov/forms/files/fin105\\_cmir.pdf](http://www.fincen.gov/forms/files/fin105_cmir.pdf) (requiring, with some exceptions, those entering or leaving the United States to declare amounts in excess of \$10,000); [http://www.frbatlanta.org/documents/rprf/rprf\\_pubs/130117\\_wp.pdf](http://www.frbatlanta.org/documents/rprf/rprf_pubs/130117_wp.pdf).

297. ROLE OF CENTRAL BANK MONEY, *supra* note 292, at 10–11.

298. Andrew P. Morriss & Jason Korosec, *Private Dispute Resolution in the Card Context: Structure, Reputation and Incentives*, 1 J.L. ECON. & POL'Y 393–472 (2005) (describing credit card payment system).

299. Patrick M. Jost & Harjit Singh Sandhu, *The Hawala Alternative Remittance System and its Role In Money Laundering*, FINCEN (n.d.), at 5–8, available at <http://www.treasury.gov/resource-center/terrorist-illicit-finance/Documents/FinCEN-Hawala-rpt.pdf> (describing system); Vanessa Clark, *The Sleeping Giants of African Mobile Payments*, TECHCRUNCH (Oct. 28, 2012) <http://techcrunch.com/2012/10/28/the-sleeping-giants-of-african-mobile-payments/> (describing system).

be attempting to protect the ownership of the property from confiscation by law enforcement officials by using Janet as a straw purchaser). Or perhaps Sarah is the actual owner of the property but has listed it in Bill's name to avoid having her name on the public record, for either legitimate or nefarious reasons. Janet's and Bill's banks can therefore not simply rely on the information given them by Janet and Bill if they are to make a determination about the true beneficial owner of the account, but must also seek information on the source of the funds Janet is using (e.g., by asking to see financial records) and the source of the ownership of Bill's house (e.g., by asking to see records documenting how he acquired it and the source of any funds used to do so).

Moreover, it is obvious where physical persons and physical objects are; it is less obvious where legal persons like companies and trusts are located. Legal persons exist only in law, and are granted attributes, including rights and powers, only by the operation of law. Legal persons have many of the rights to do things that physical persons possess, such as own property and enter into contracts, and to sue and be sued for breach of someone else's legally protected interest. Banks are organized as legal persons, and may have physical "brick and mortar" locations for management, computers, employees, and even vaults to hold physical currency. In general, the bank's "location" is where it received its banking charter and where it is subject to primary regulation and supervision. If, for example, Bank A is headquartered in London, then the U.K. regulatory authority will exercise primary jurisdiction over it.<sup>300</sup> However, as a general matter, jurisdictions prefer that banks that wish to operate within their borders—which means that they offer banking services directly to the jurisdiction's residents first secure a local charter and be subject to local regulation and supervision.<sup>301</sup> This means that the multinational branches of Bank A that are located in other jurisdictions, will have separate banking licenses in each place and are subject to supervision in each place, even if those branches are completely owned and controlled by Bank A. From the perspective of the person transferring money

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300. Raj Bhala, *Cross Border Electronic Banking: Perspectives on Systematic Risk and Sovereignty*, in 5 *CURRENT ISSUES AFFECTING CENTRAL BANKS* 107, 114-120 (1998).

301. *Id.* Over time, mechanisms have been put in place to ensure effective supervision in difference jurisdictions, and to coordinate supervision among jurisdictions when a bank has a presence in more than one. Gordon, *On the Use and Abuse*, *supra* note 168, at 541-63.

internationally – meaning the person transferring a claim from, say, Bank A to Bank B, its branch in Japan – what matters is that Bank B respects and enforces that transfer. Similarly, in a nonbank transaction (e.g., via a hawala network), what matters for the person transferring the money is that the other participants in the network are trustworthy. In large part for banking networks, this means that the person transferring the claim can trust the supervisory authorities and the courts in Japan. But from the point of view of identifying the beneficial owners of the resources being transferred, quite different information will also be needed. Crucially, this information has little or nothing to do with the functioning of the system of transfers. Collecting and disseminating that information increases the cost of conducting transactions.

In the course of millions and billions of both national and international transactions each day, much netting goes on among deposit-taking banks and central banks, and of course, most of this is done via electronic instruction implemented by various interconnected record-keeping systems.<sup>302</sup> But when one refers to the “international movement of money,” one is really referring to the shifting claims among people and banks that are subject to the regulation and supervision of different jurisdictions. Once that money is used to purchase a good, a service, or an asset, the person now owns either a fleeting benefit or a more lasting one. Getting these transfers “right” is quite important to the participants: both a U.S. company paying its Chinese supplier and the supplier want to be sure the payment goes to the correct entity in China. Not surprisingly, international financial institutions have invested in ensuring they can accomplish these transactions as the participants desire. Their investment in control infrastructure to accomplish governmental aims is quite different, since it does not advance the financial institutions’ businesses.

Moreover, the development of “non-equity and contractual forms of association, the so-called New Forms of Investment (NFI) that have been growing rapidly” since the 1980s, complicates things still further.<sup>303</sup> These include “licensing agreements, franchising,

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302. Bhala, *supra* note 300, at 108–110.

303. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 16. See also ALBI, *Challenges*, *supra* note 7, at 131 (incentive to shift to unincorporated entities created by corporate taxation); Boadway & Keen, *supra* note 75, at 54 (“the world has become more complex ... [as] even the distinction between debt and equity has become less clear-cut with the development of such instruments as the monthly income



subcontracting, management contracts and joint ventures,"<sup>304</sup> and "are an important new feature of the global financial structure." Multiple layers of agreements exist in such cases and the complexities will quickly overwhelm any effort at standardized reporting. For example, Stopford et al., describe the evolution of Firestone's Kenya investment in the 1970s from a majority stake in a firm with local owners holding a minority interest, with a royalty arrangement negotiated directly with the country's president to a minority stake in a firm majority owned by Kenyans, with a management fee on net sale that was twice earlier fees, higher prices and lower interest rates allowed because of the local majority ownership, and a monopoly on imports of types of tires not made locally.<sup>305</sup> They conclude "Firestone increased its profit flow from Kenya with reduced asset exposure and risk."<sup>306</sup> None of these features would fit easily into even the most rigorous reporting framework being discussed today. These forms of investment are "invisible investments," just as earnings of foreign exchange by sale of banking, insurance, and other services to foreigners are described as "invisible exports." "Essentially, what the firm is doing is to reap an additional return on the capital already invested at home in developing the product by transferring its knowhow across frontiers."<sup>307</sup> Such investments may not even appear in any financial institution's accounts. How would the "beneficial owner" of a contractual right be identified?

It is this system of transferring claims from banks in different jurisdictions that permits governments, firms, and individuals to engage in economic activity that is not bound by national borders. It is, in short, what permits a modern global economy to function

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preferred shares (treated in the United States as debt for tax purposes, but equity for accounting purposes).").

304. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 48 (quoting UNCTC).

305. *Id.* at 148-49.

306. *Id.* at 149.

307. *Id.* at 48. For example, Stopford et al., cite an example of General Motors sending "at its own expense" a "regiment of engineers" to Brazil from Detroit for "months" in the 1980s to assist Brazilian suppliers in meeting GM's requirements so that GM could comply with local content laws. These engineers, paid in the United States, were a transfer of services to the Brazilian companies but almost certainly did not appear as income on the Brazilian firms' tax returns as income, although they would have been expensed by GM in the United States. This boosted GM's operations in Brazil, effectively shifting income from the United States to Brazil. *Id.* at 48-49.

with considerably less value lost to transaction costs. Efficient Enterprisers applaud this system; it minimizes transaction costs and thereby allows a more efficient system of creating wealth. In doing so, it also fosters jurisdictional competition by rewarding those countries where keeping and transferring claims are most efficient and the least risky. However, Control Firsters find this system troubling, arguing that it represents some kind of nefarious, secret international "movement" of wealth, when it is essentially an expanded version of the system used domestically. What is different with respect to the use of offshore centers as intermediaries is that the person "moving" the funds from an onshore center has chosen to use the legal and managerial benefits of an offshore center rather than to continue to use those of his own jurisdiction. We have already noted the possible efficiency benefits of investors choosing superior legal systems, and that offshore centers may have a comparative advantage in this area. We have also shown that offshore centers have superior records with respect to implementing anti-money laundering standards, and that they have been cooperative at implementing the ever more onerous and expensive reporting and transparency rules demanded by onshore tax authorities. Given that offshore centers have a recent history of solid banking supervision,<sup>308</sup> there can be no reason to infer nefarious activity when money is "moved" through an offshore center. In fact, in view of the recent history of banking problems in onshore jurisdictions in the United States and Europe, the use of offshore center banks makes a good deal of sense.

An added wrinkle arises in dealing with intra-firm transfers. Intra-firm trade is an important part of international trade.<sup>309</sup> Not only do firms trade with each other, different divisions within firms trade across borders.<sup>310</sup> These trades require that the firm make bookkeeping entries both internally and in accounts in financial institutions. In the regular course of business, such transfers of claims shift revenues between jurisdictions and can fall afoul of tax regulations without any ill intent. For example, Mo describes a U.S.-China transaction in which a Sino-U.S. joint venture marketed

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308. Gordon, *On the Use and Abuse*, *supra* note 168, at 562-63.

309. Mo, *supra* note 188, at 7 (noting that "a significant proportion of foreign trade [in China, Brazil, and Mexico] consists of transactions between related entities of ... multinationals.").

310. BEENHAKKER, *supra* note 30, at 31.

detergent in China by attaching a free box of stain remover to each box "Because the small boxes of stain remover were treated as free gifts, the joint venture transferred the stain remover at cost, thus reporting no profits in China. Since the stain remover cannot be sold in the market separately, there was no market price readily available. Although all information including the costs had been disclosed, the transfer of stain remover at full cost was considered 'unacceptable' avoidance and against the spirit of the law, which normally expects a return from a joint venture investment."<sup>311</sup> The complexity necessary to cope with modern business arrangements makes transfer pricing regulation costly to design and implement.

Of course, it is certainly true that one goal in shifting revenues is to minimize taxes net of avoidance costs. However, tax avoidance is merely one goal among many. For example, any tax minimization strategy must also take into account factors such as impacts on divisional operating results,<sup>312</sup> import duties,<sup>313</sup> harmony among divisional managers,<sup>314</sup> currency fluctuations,<sup>315</sup> overall and local competitive positions,<sup>316</sup> the role of foreign partners in subsidiaries,<sup>317</sup> and labor relations.<sup>318</sup> The decisions on allocating costs are made by managers who are not always focused on minimizing net tax payments as their goal. Taking all these factors into account, Shulman concluded that corporate management needs for measurement, evaluation, and motivation were significant determinants of multinationals' "control systems" and a "willingness to tinker incessantly with transfer prices" was "dysfunctional."<sup>319</sup> Moreover, what revenue authorities perceive as overly aggressive tax minimization strategies can also attract regulators' attention and companies may value minimizing tax investigations over tax savings.<sup>320</sup>

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311. Mo, *supra* note 188, at 3.

312. James S. Shulman, *TRANSFER PRICING IN THE MULTINATIONAL FIRM* (1968 [2011 reprint edition]), at 5.

313. *Id.* at 5.

314. *Id.* at 7.

315. *Id.* (firms strive to move funds out of countries with inflation).

316. *Id.* at 11-12.

317. *Id.* at 13.

318. *Id.* at 14 (noting that Mexican requirement of profit sharing with employees meant local profits must be "reasonable" to avoid labor strife).

319. *Id.* at 19-20.

320. *Id.* at 6 ("Another company neglects the impact of taxes on pricing entirely,

These are not simple problems to manage. For example, Shulman reported that a multinational operating in Brazil in the 1960s, when inflation there was high, preferred to ship goods to its Brazilian subsidiary at a low price "to assist it in profitable operation" and because the Brazilian government required importers to post of a cash deposit equal to six months imports, and the deposit lost value due to inflation. However, another multinational operating in Brazil at the same time preferred to charge its local subsidiary a high price, to get its money earned out of the high inflation environment, despite having to lose money on the cash deposit and pay higher taxes on the reported profits in the United States.<sup>321</sup> Which set of transfer prices were "correct"?

Even where transfer-pricing efforts are aimed at shifting resources between jurisdictions, they may not be motivated primarily by tax considerations. For example, where local laws prohibit remission of royalties abroad, increasing the transfer prices of goods can substitute for royalty payments.<sup>322</sup> Is this an illegitimate evasion of local law or a reaction to a legal system banning one transaction but permitting another?<sup>323</sup> Which "intent" matters—the intent to ban royalty payments or the intent to permit sales? Similarly, is use of higher transfer prices to shift resources out of a country where the resource owner fears expropriation a legitimate reaction to uncertainty over political risk or illegitimate evasion of "legal" confiscation of foreign-owned assets?<sup>324</sup> Shulman describes how one company used this to avoid losses from expropriation during and after the Cuban Revolution.<sup>325</sup>

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arguing that simple and consistent pricing practices tend to minimize tax investigation problems.").

321. *Id.* at 8.

322. *Id.* at 9.

323. Consider that Delaware treats each section of its corporate law as having "independent legal significance." *Orzech v. Englehart*, 195 A.2d 375, 365 (Del. 1963) ("[A]ction taken in accordance with different sections of that law are acts of independent legal significance even though the end result may be the same under different sections.") It is a "bedrock" of Delaware jurisprudence. *Warner Commc'ns Inc. v. Chris-Craft Indus., Inc.*, 583 A.2d 962, 970 (Del. Ch.) *aff'd* 567 A.2d 419 (Del. 1989). The doctrine "has played a role in many of Delaware's landmark decisions." Robert K. Clagg, Jr., Note, *An 'Easily Side-Stepped' and 'Largely Hortatory' Gesture?: Examining the 2005 Amendment to Section 271 of the DGCL*, 58 EMORY L. J. 1305, 1319 (2009). This doctrine is as "formalistic" as any about which the Control First advocates complain.

324. Shulman, *supra* note 312, at 10–11.

325. *Id.* at 11. Bacardi diversified out of Cuba in part out of fear of expropriation,

### B. Why Money "Moves"

Claims are transferred internationally because of individual transactions. Some of these transactions reflect transfer of funds to accomplish a business purpose: a U.S. retailer importing goods from a Chinese supplier must pay the supplier by transferring money from an account the U.S. retailer controls to one the Chinese supplier controls.

Claims are also transferred because the demand for investment opportunities and the supply of those opportunities differ across jurisdictions. In general, "capital flows out of countries where there is a surplus of saving over domestic investment opportunities into countries where there is a deficit (savings less investment)."<sup>326</sup> The Tax Justice Network argues that developing countries exporting capital is a sign of bad behavior by investors in those countries.<sup>327</sup> However, countries with persistently large savings surpluses are those where the public is "seeking to accumulate wealth (measured net of government debt) at a faster pace (in absolute terms) than the

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initially by the Batista regime. TOM BACARDI, *BACARDI AND THE LONG FIGHT FOR CUBA: THE BIOGRAPHY OF A CAUSE 198-99* (2009). By contrast, the maker of Havana Club rum, Jose Arechabala, S.A., did not diversify its rum business out of Cuba and lost its property in the Cuban Revolution. This led to a long-running dispute over the intellectual property in the "Havana Club" trademark. See Emily Taylor, *The Havana Club Saga: Threatening More than Just "Cuba Coke"*, 24 NW. J. INT'L L. & BUS. 513 (2004). *Id.* at 11. Bacardi diversified out of Cuba in part out of fear of expropriation, initially by the Batista regime. TOM BACARDI, *BACARDI AND THE LONG FIGHT FOR CUBA: THE BIOGRAPHY OF A CAUSE 198-99* (2009). By contrast, the maker of Havana Club rum, Jose Arechabala, S.A., did not diversify its rum business out of Cuba and lost its property in the Cuban Revolution. This led to a long-running dispute over the intellectual property in the "Havana Club" trademark. See Emily Taylor, *The Havana Club Saga: Threatening More than Just "Cuba Coke"*, 24 NW. J. INT'L L. & BUS. 513 (2004).

326. BRENDAN BROWN, *WHAT DRIVES CAPITAL FLOWS? MYTH, SPECULATION AND CURRENCY DIPLOMACY* 2 (2006).

327. See, e.g., Henry, *supra* note 4, at 23 ("since net outflows from developing countries have continued over sustained periods of time, and since little offshore wealth or the earnings that it produces have been repatriated, the most important factors driving it are not those that drive 'hot money,' but long-term decapitalization."). Interestingly, *The Price of Offshore Revisited* does not discuss the temporary, targeted control of capital flows during periods of great financial instability. Such temporary controls can be used to stabilize large and temporary swings in exchange rates or to prevent large and temporary currency runs that can lead to defaults. IMF, *The Liberalization and Management of Capital Flows, An Institutional View* (Nov. 13, 2012), available at <http://www.imf.org/external/np/pp/eng/2012/111412.pdf>. We do not address such temporary capital controls in this paper.

expansion of the domestic capital stock."<sup>328</sup> Where money can move freely, there is no reason to expect savings and investment to balance within a jurisdiction. Chinese citizens have a high savings rate;<sup>329</sup> U.S. citizens a much lower one.<sup>330</sup> If opportunities to invest internationally exist for Chinese investors, this will cause a movement of capital from China to the United States. (For political reasons and because of the restrictions on the convertibility of the Chinese currency, the Chinese government undertakes a major portion of Chinese investment into the United States).<sup>331</sup> A substantial amount of money moves for this reason, as "[t]he main ultimate sources of net capital outflows are the advanced economies in East/South East Asia (Japan, South Korea, Taiwan, Hong Kong, and Singapore), with an estimated \$230 billion, Middle East oil exporters, \$220 billion, Western Europe excluding the United Kingdom (euro-area, Switzerland, Norway, and Sweden), \$120 billion, and Asian-developing countries (China, India, and others), \$130 billion."<sup>332</sup>

Claims are also transferred because of firms' and individuals' investment preferences. There may be more investment opportunities of a desirable type in one jurisdiction rather than another, which will draw funds in. The desirability of the investment may be due to the presence of natural resources, relative labor costs, or other advantages related to factors of production. But it may also be related to the desirability of the legal and regulatory framework provided by a jurisdiction. Particularly for international investors, the agency problems involved in portfolio investment are significant. Moreover, investment across borders may occur because firms and individuals desire asset diversification.<sup>333</sup> Asset diversification will do more than

328. BROWN, *supra* note 326, at 7.

329. Guonan Ma & Wang Yi, *China's High Savings Rate: Myth and Reality*, Bank for International Settlements (Working Paper No. 312, June 2010), available at <http://www.bis.org/publ/work312.pdf> (Chinese savings rate exceeded 50% during 2000s).

330. *Id.* at Table 1 (noting U.S. savings rate was under 20% during 2000s).

331. See Philippe Gugler and Bertram Boie, *The Emergence of Chinese FDI: Determinants and Strategies of Chinese MNE* 4-5 (Oct. 9-10, 2008), available at <http://gdex.dk/ofdi/20%20Gugler%20Philippe.pdf> (until 2003, outward Chinese investment was principally only allowed by state-owned enterprises. Since then, the Central government has maintained the lion's share of outward FDI (73.5% in 2003, 82.3% in 2004, and 83.2% in 2005)).

332. BROWN, *supra* note 326, at 19.

333. *Id.* at 8 ("A considerable amount of two-way capital flows can be explained

lead to reciprocal swaps between jurisdictions: investors from jurisdictions which are less stable, which have poorer economic performance, or which provide less robust property rights protections will need to diversify out of their jurisdictions more than will those in stable, better performing economies with strong property rights protections. Claims are transferred under many labels in business deals. Firms evaluating investment projects care about all of the cash flows generated. These include "dividends, *plus* royalties, management fees, trademark fees and the effects on profitability of operations in other countries."<sup>334</sup>

In addition, capital flows towards deep, well-functioning capital markets where it can then find its way on to appropriate investments.<sup>335</sup> There is an important role for capital markets as aggregators and repackagers of funds that will travel on to other destinations. Indeed without introducing some real world facts such as "currency risk, political risk, and other heterogeneous factors, we would have a hard job explaining a salient feature of global capital flows—the turntable."<sup>336</sup> A "turntable" is "the phenomenon of a country (or group of countries forming a currency area) importing capital on a net basis from another region of the world and exporting it (net) to another. Typically the turntable would import capital from the savings surplus countries and re-export (capital) to the savings deficit countries. Turntables can also

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by the simple arithmetic of diversification. If there were no home biases (preference to hold domestic rather than foreign assets) investors in any country would tend to hold the same portfolio of assets drawn from all over the world. That would mean large inflows and outflows of capital being the norm for each country as part of the process of wealth accumulation. Relative to national income these would be greater for small countries (whose assets formed only a small part of the world portfolio) than for large.").

334. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 150.

335. London has long played this role. Catherine Schenk describes it in the 1960s as

London was a genuine entrepôt where financial institutions intermediated between customers abroad and between domestic and foreign customers. This reflected the sophistication of financial services that had been developed over the past century; through the Gold Standard, the subsequent pre-eminence of sterling, and the role of Britain as the world's major trading nation.

Catherine R. Schenk, *International Financial Centres, 1958-1971: Competitiveness and Complementarity*, in *EUROPEAN BANKS AND THE AMERICAN CHALLENGE: COMPETITION AND COOPERATION IN INTERNATIONAL BANKING UNDER BRETTON WOODS 74*, 78 (Stefano Battilossi & Youssef Cassis eds., 2002).

336. BROWN, *supra* note 326, at 8.

have relationships with each other.<sup>337</sup>

Often assets are repackaged in capital markets, changing their legal characteristics. Thus a dollar moved from New York to London becomes a “Eurodollar” rather than a “dollar,” and is capable of being held at a lower cost by a financial institution in London than it would be in New York.<sup>338</sup> This is because a London bank holding a dollar is not required by either the Bank of England or the Federal Reserve to set aside the same level of reserves for lending based on that dollar as the Bank would require for a British bank holding an equivalent amount in sterling or the Federal Reserve would for a U.S. bank holding the dollar in the United States.<sup>339</sup> The loan can thus be made at a lower cost than it would otherwise be and the deposit can be paid a higher rate than it would otherwise receive.<sup>340</sup> There is nothing illegitimate about this—it merely reflects the lower transactions costs of packaging a particular set of claims in large sizes and outside of the reserve requirements imposed on more retail banking operations. Moreover, the Eurodollar market expanded in part in response to corporate treasurers’ efforts to maximize the value of their short-term cash

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337. *Id.* at 8-9. There are well-documented examples of turntable effects. For example, Brown describes how in 2003-04, savings surpluses in Asia (particularly from Japan and the more advanced economies in east and south Asia) were filling the U.S. savings deficit. Because Asian investors wanted not just U.S. assets but also euro-area assets, and euro-area residents sought to borrow low interest yen to finance euro-area activity, Asian funds flowed into the euro-area, while euro-area funds flowed out of the euro-area. *Id.* Similarly, in 1999-2000, European investors were buying U.S. equities and companies, while a global demand for euro-area assets was appearing in reaction to the new European currency and development of deeper capital and money markets in Europe that resulted. *Id.*

338. ROBERT Z. ALIBER, *THE INTERNATIONAL MONEY GAME* 176-80 (5th ed. 1987) (describing operation of Eurocurrency markets). For the role of Eurocurrency markets in the development of the Cayman Islands as an offshore financial center, see Freyer & Morriss, *supra* note 8, at 18-21.

339. ALIBER, *supra* note 338, at 179-80. In a further example of how regulatory policies create new financial markets, American banks moved into Europe in the 1960s in part as a response to the Kennedy Administration’s creation of the Interest Equalization Tax in the United States, which was intended to increase the cost of foreigners and U.S. companies with foreign operations raising capital in the United States. Stefano Battilossi, *Introduction: International Banking and the American Challenge in Historical Perspective*, in *EUROPEAN BANKS AND THE AMERICAN CHALLENGE*, *supra* note 335, at 1, 14. Thus the system that Control Firsters object to grew in response to an effort to restrict legal capital export from the United States, precisely the sort of policy they endorse today.

340. ALIBER, *supra* note 338, at 176-77.



holdings, not tax-based motives.<sup>341</sup> It grew further as banks switched from asset management to liability management as their strategy for matching assets to liabilities on their books.<sup>342</sup> In addition, routing money through sophisticated financial institutions offers the opportunity to build in regulatory measures to protect lenders.<sup>343</sup>

Of course, some claims are transferred as part of a criminal enterprise. For example, Colombian cocaine exporters need to be able to spend money in Colombia that was generated by the sale of their cocaine in the United States. Similarly, claims may be transferred across jurisdictional boundaries to another to pay for terrorist activity. Claims may also be transferred because they represent stolen assets (either by private actors or by political actors) in one jurisdiction and an attempt is being made to hide the assets in another.

A key difference between the two frameworks described above concerns the legitimacy of the constraints imposed by flows of claims. (We discuss the Tax Justice Network's effort to estimate the size of illegitimate flows in the next section.). If individual decisions by firms and individuals to move money from one jurisdiction to another reflect decisions about how best to allocate their resources, broad trends in money movements provide information on how jurisdictions are perceived by economic actors and reflect economic activity. A jurisdiction whose government found itself constrained by such pressures because its policies made it an inhospitable place for investment would have to choose between continuing the

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341. Stefano Battilossi, *Banking with Multinationals: British Clearing Banks and the Euromarkets' Challenge, 1958-1976*, in *EUROPEAN BANKS AND THE AMERICAN CHALLENGE*, *supra* note 335, at 103, 104.

342. *Id.* at 107 ("Both CDs and Eurodollars represented key factors that allowed banks to strengthen the liability side of their balance sheet, by compensating shrinking deposits with funds borrowed at market rates. By doing so, they promoted a radically different way of banking, based on what was known as 'liability management', under which commercial banks increasingly tended to accommodate liabilities to loan demand by borrowing funds in the money markets.").

343. MILLER & CAFAGGI, *supra* note 35, at 21 ("Credit agreements, in short, can operate as a reasonably comprehensive regulatory systems, entered into by private contract and not compelled by any government action."). As Miller and Cafaggi note, lenders monitor performance and verify the borrower is in compliance with the terms, a valuable service. *Id.* at 22. In general, they note that "[b]y far the greatest share of standard-setting and enforcement is conducted by private actors" through various private bodies and agreements. *Id.* at 26.

policies and suffering the consequences or changing the policies. For example, Papaioannou concludes "the evidence implies that improving inefficient bureaucracies, tackling corruption, and enhancing legal system competence are crucial for attracting foreign bank capital" and that "political liberalizations, privatization and other structural policies (which are followed by a decline in political risk), can enhance domestic liquidity by attracting substantially more foreign capital."<sup>344</sup> Thus Venezuela's economy is experiencing significant inflation (bordering on hyperinflation) largely as a result of the Venezuelan government's policy choices.<sup>345</sup> Efficient Enterprises proponents see this is a market reaction to the institutional environment presented by the government's choices.<sup>346</sup> Control First proponents see this as a barrier to governments' ability to adopt policies.<sup>347</sup> In addition, they argue that illegitimate motives drive a substantial number of decisions to move money across borders. Because they view tax avoidance as illegitimate, they reject jurisdictions' ability to compete for wealth creation through creation of a favorable investment climate.

Capital markets discipline governments to some extent, although the degree varies with the degree of openness to the world economy. Governments seek to avoid such discipline; as a former

344. Elias Papaioannou, *What Drives International Bank Flows? Politics, Institutions & Other Determinants* 29 (Nov. 2004), available at <http://www.ecb.de/events/pdf/conferences/ecbimf/paper.paioannou.pdf>.

345. See Ezequiel Minaya, *Venezuelan Inflation Surges*, WALL ST. J. (July 9, 2013), <http://online.wsj.com/article/SB10001424127887324507404578596153737072578.html>; Benedict Mander, *Venezuela hit by fears of hyperinflation and recession*, FIN. TIMES (June 9, 2013) <http://www.ft.com/intl/cms/s/0/b41fbc4-d0f1-11e2-be7b-00144feab7de.html#axzz2cGeeJiQS> (attributing inflation to "a tangled web of price and currency controls which, together with problems in the oil industry that supplies 96 per cent of export revenues, have generated a shortage of foreign currency, on which the import-dependent economy relies.").

346. Markets react to government policies. See Jeffry A. Frieden, *The Politics of Exchange Rates*, in MEXICO 1994: ANATOMY OF AN EMERGING MARKET CRASH 81 (Sebastian Edwards & Moises Naim eds., 1998). See also Arminio Fraga, *Capital Flows to Latin America*, in INTERNATIONAL CAPITAL FLOWS 50 (Martin Feldstein ed. 1999) (describing how capital controls gave central bank in Brazil "a false sense of security and probably allowed Brazil to avoid or postpone a number of important macroeconomic policy changes and structural reforms.").

347. See, e.g., Henry, *supra* note 4, at 25-26 ("that when the public sector has been starved for capital (perhaps having had to rely on high-cost loans or inflationary finance rather than tax revenue), the rate of return on public investments is often higher than on private investment. Tax, by producing better roads and educated populations and so on, can 'crowd in' private investment, rather than crowd it out as many people believe.").

Brazilian central bank economist noted, "[g]overnments, for whatever reason, usually for political reasons, often try to defend situations that are clearly unsustainable."<sup>348</sup> Similarly, economists Reuven Glick and Michael Hutchinson concluded an empirical study of efforts to prevent financial crises through capital controls by noting that "[e]xtensive capital controls and other restrictions on exchange payments may contribute to greater vulnerability of countries to currency crises by leading to inconsistent policies, poor policy design, and, at worst, substantial corruption in the financial and international sector that eventually erodes confidence in the exchange rate system."<sup>349</sup> A government that chooses to isolate itself can survive without such links, at considerable cost. For example, both Iran and North Korea have managed to maintain regimes despite considerable outside financial pressures.<sup>350</sup> However, the Mitterrand government in France in the 1980s "was forced by the external deficits and the exhaustion of foreign credit into a major U-turn in policy away from state-owned enterprises and organized labour and toward productivity in export industries."<sup>351</sup> Were the constraints imposed on the Mitterrand government analogous to those imposed by the laws of physics (e.g., a feature of the natural world to which politicians must adjust) or the result of undemocratic behavior by outside speculators? Efficient Enterprisers tend to see such pressures as the former, Control Firsters as the latter.

In more connected economies, the pressures from capital markets can be even more significant. For example, capital market

348. Fraga, *supra* note 346, at 50.

349. Reuven Glick & Michael Hutchinson, *Stopping 'Hot Money' or Signaling Bad Policy? Capital Controls and the Onset of Currency Crises* 27 (2000), available at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.202.3623&rep=rep1&type=pdf>.

350. See KENNETH KATZMAN, CONG. RESEARCH SERV., RS20871 IRAN SANCTIONS, (2000), available at <http://www.fas.org/sgp/crs/mideast/RS20871.pdf> (detailing some of the methods Iran has implemented as a work-around to trade embargos and noting that "Government-linked entities are creating front companies and making increased use of barter trade. Iranian traders are using informal banking exchange mechanisms and, benefitting from the fall in the value of Iran's currency, increasing non-oil exports such as agricultural goods, minerals, and industrial goods. Affluent Iranians are investing in hard assets such as real estate."); Robert Carbaugh, *Are Economic Sanctions Useful in Discouraging the Proliferation of Weapons of Mass Destruction*, 9 *World Econ.* 181, 191-192 (Oct. 2008) (arguing that only about a quarter of U.N. countries actively participate in sanctions against North Korea).

351. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 206.

discipline has made policies aimed at overvaluing currencies unsustainable, with the benefit of discouraging inefficient importation of capital-intensive producer goods and luxury consumer goods.<sup>352</sup> Even in this constrained world, governments “retain considerable *negative* power to disrupt, manage or distort trade by controlling entry to the territory in which the *national* market functions. They cannot so easily control production which is aimed at a *world* market and which does not necessarily take place within their frontiers.”<sup>353</sup> This discipline helps restrain governments from adopting policies in which politics, rather than markets, allocates scarce resources.<sup>354</sup>

Capital markets exert discipline by offering capital alternatives to local investments when governments adopt policies that reduce rates of return. For example, Russia experienced considerable capital flight during 2008 (\$74 billion of foreign capital left Russia between August and October 2008).<sup>355</sup> Wealthy Russians also lost money during this time: Russian oligarchs were estimated to have lost \$230 billion in this same period.<sup>356</sup> Presumably additional capital left Russia by both recorded and unrecorded means. Why did this happen? One possible explanation is Russian citizens were illegitimately evading the controls on their wealth and behavior that their government sought to impose so it could collect taxes to fund public goods. Another possible explanation is that Russia was an economy where the

most powerful companies control natural resources-so wealth stems not from human capital but from the willingness of a select group of financially skilled oligarchs to support the policies of the existing power structure in exchange for control of those natural resources. Russia uses its court system to harass executives who speak in opposition to government policies. And its financial markets lack the transparency and depth to support IPOs. . . . [T]hrough its willingness to oust executives representing Western interests. . . . Russia sent a strong signal to foreign capital

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352. *Id.* at 107.

353. *Id.* at 14.

354. *Id.* at 170 (“Where the state becomes both the engine of development and the arbiter of social relations, benefits are distributed by ‘concessionary’ bargaining with local and foreign groups. Over time, state-controlled dispensation of ‘favours’ becomes important for maintaining the regime.”).

355. COHEN & RANGAN, *supra* note 18, at 33.

356. *Id.*

providers that it would be happy to take outside capital but that it would not allow that capital to earn a return on it. Rather, Russia provided a stark example to those foreign capital providers that it would use its court system to drive out the representatives of its Western partners and take full control of the venture once it had the foreign capital it needed to launch it.<sup>357</sup>

Were anti-oligarch efforts legitimate or illegitimate? Partly both? How does one tell? Similarly, Malaysia, a prominent "victim" of capital flight, had a policy of discrimination in employment, education, and investment against its ethnic Chinese and Indian citizens, which created "both an exodus of talent from the country and capital flight."<sup>358</sup> Were the anti-Chinese and anti-Indian policies legitimate policies to which its citizens of Chinese and Indian origin were morally obligated to submit or illegitimate acts they could legitimately resist by shifting assets out of the country by any means available? Moreover, then-Prime Minister Mahathir's public attacks on hedge funds not only made Malaysian businesses fearful about additional losses in value but also signaled weakness to currency markets and attracted more speculative attacks.<sup>359</sup> Should Malaysia have been insulated from the consequences of Mahathir's statements?

Control First proponents focus almost exclusively on instances in which governments are robbed by corrupt politicians and bureaucrats in collusion with private sector actors, as in the Angola-Russia example discussed earlier.<sup>360</sup> They are thus able to ignore arguments based on questionable behavior by governments. The Tax Justice Network dismisses the idea that tax competition has beneficial effects on governments by blithely stating that despite it being "very hard to defend 'tax enforcement at any price' when the tax collector is the Burmese junta, Gaddafi's Libya, or perhaps even the City of Chicago," "[o]ur sense . . . is that most countries operate very, very

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357. *Id.* at 34.

358. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 124. See also DE BROUWER, *supra* 36, at 100 (noting that capital flight from Malaysia in November-December 1997 of approximately \$30 billion was "largely in response to the domestic banking crisis and persecution of ethnic Chinese.").

359. *Id.* at 110. In addition, "[t]he ferocity, emotionalism and anti-Semitism of Mahathir's comments was an affront to many speculators and widened the motivation of their activity from simply making money to include an element of retribution. In the words of some market participants, Malaysia became an 'ego play.'"

360. See notes 128 to 129 *supra*.

far from this hypothetical 'tax compliance vs. freedom-and-prosperity margin,' along which increased tax competition and reduced compliance automatically leads to increased liberty, entrepreneurship, and growth."<sup>361</sup> As this quote illustrates, rather than providing discipline that pushes governments to adopt policies that promote economic growth, Control First proponents argue that international financial institutions promote policies that facilitate looting public treasuries. They argue that what is needed is enhanced control over financial flows to prevent money from leaving the jurisdictions where it is being looted. At a minimum, this requires powerful assumptions about the mix of legitimate and illegitimate actions by governments. We now turn to analyzing the Tax Justice Network's attempt to estimate illegitimate movement of money.

### *C. How Much Illegitimate Movement of Money Occurs?*

As we have discussed above, there are policy questions that need to be resolved in making choices about how to treat the movement of money. In addition, there are factual ones: there are disagreements over what types of transactions are occurring, why transfers occur, and where claims are ultimately being recorded. As noted earlier, one of the main arguments Control First proponents make is that illicit flows are large. In this section, we examine the estimate made by the Tax Justice Network in its report *The Price of Offshore Revisited*. To the extent that we are interested in understanding the costs and benefits of particular policies—to weigh the costs and benefits of particular measures aimed at either enhancing the free flow of money or restricting it in pursuit of increasing tax collections or decreasing the funds available to criminals—the calculation will be affected by the magnitudes of legitimate and illegitimate flows involved.

Unfortunately, data on transactions, which are, by definition, unreported is unsurprisingly hard to come by. As a result, Control First interest groups seek to establish large estimates to set the baseline for the debate on turf favorable to their efforts to exert controls over financial flows. In this section, we examine the most recent effort to establish the benchmark by the Tax Justice Network. We use *The Price of Offshore Revisited* for this because it is the most recent effort, it claims to be the most comprehensive estimate,<sup>362</sup> and

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361. Henry, *supra* note 4, at 25.

362. *Id.* at 40.

it is widely cited as authoritative in public debates over financial control measures.<sup>363</sup> Analyzing the best case scenario for the Control First approach is useful both to understand how the policy debate is being conducted, and because the weaknesses in the effort reveal how dependent the Control First argument is on strong assumptions about the nature of financial activity. It is worth noting, however, that TJN's estimate is an outlier even among other estimates by ideologically sympathetic sources. As TJN itself notes, its estimate in *The Price of Offshore Revisited* is substantially larger than either its own 2005 estimate or the estimates made by others who agree with TJN on policy preferences.<sup>364</sup> That itself is a reason to be cautious in putting too much weight on the largest estimate.

There are other reasons to be cautious. *The Price of Offshore Revisited* purports to use "a more open, transparent, collaborative model for doing such research so that the data sources, estimation methods, and core assumptions are all exposed to the sunlight of peer review, and ultimately to public scrutiny."<sup>365</sup> To date, no such materials have appeared on its website beyond a PowerPoint presentation lacking crucial details. When we asked a research assistant to contact the author and the Tax Justice Network in 2012 and 2013 to obtain the details of the model and the data that was not reported in the report, he received no reply despite multiple emails and other messages. For an organization promoting an "open, transparent" approach, the Tax Justice Network proved remarkably opaque and closed about its methodology. In addition, TJN, and Henry, are fond of quotations of anonymous "officials" who say witty things such as: "The problem is not that these countries do not

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363. See, e.g., Yenni Kwok, *Global Super-Rich Hide \$21 Trillion in Tax Havens*, CNN.COM (July 25, 2012) <http://edition.cnn.com/2012/07/23/business/super-rich-hidden-wealth-offshore>; Lyneka Little, *Super-Rich Hide \$21 Trillion in Secret Tax Havens, Says Tax Justice Network*, ABC NEWS (July 23, 2012) <http://abcnews.go.com/blogs/business/2012/07/super-rich-hide-21-trillion-in-secret-tax-havens-says-tax-justice-network/>; Mary Carroll, *Brazil's Wealthiest Hide US\$520B: Daily*, THE RIO TIMES (July 23, 2012), <http://riotimesonline.com/brazil-news/rio-business/brazils-wealthiest-hide-us520b-in-offshore-accounts/#>; *Tax havens: Super-rich 'hiding' at least \$21tn*, BBC NEWS (July 22, 2012) <http://www.bbc.co.uk/news/business-18944097>. Remarkably, these stories accept the claims made in the report uncritically and do not present alternative views.

364. Henry, *supra* note 4, at 34-35. The earlier report is a 2 page "briefing paper." TAX JUSTICE NETWORK, *The Price of Offshore* (2005), available at [http://www.taxjustice.net/cms/upload/pdf/Briefing\\_Paper\\_The\\_Price\\_of\\_Offshore\\_14\\_MAR\\_2005.pdf](http://www.taxjustice.net/cms/upload/pdf/Briefing_Paper_The_Price_of_Offshore_14_MAR_2005.pdf).

365. Henry, *supra* note 4, at 5.

have any assets. The problem is, they're all in Miami."<sup>366</sup> Sprinkling the report with such quips improves its readability but adds nothing to its legitimacy. TJN also relies heavily on unsupported factual assertions. For example, it claims that, "we also know for a fact that wealthy investors from these ["key" Latin American] source countries [such as Venezuela and Mexico] account for a significant share of US bank deposits owned by non-residents."<sup>367</sup> How does TJN know this? They do not say. This is not information made publicly available by banks or regulators and factual claims about it require support if they are to be taken seriously. What is a "significant" share? Who knows? The report is opaque on the crucial details about how its estimate was constructed, which is ironic in light of TJN's focus on demanding that others to be transparent. Since it is impossible to reverse engineer the estimates based on the information provided in the report, we examine what TJN reveals about its methodology and probe the assumptions underlying it. We then focus on the "corrections" and "adjustments" TJN makes to its model's estimates.

### 1. Methodology & Assumptions

TJN's methodology and its implicit assumptions are problematic as a basis for public policy for five main reasons. To begin with, *The Price of Offshore Revisited* focuses on "measuring long-term un- recorded cross-border private financial capital flows and stocks."<sup>368</sup> It begins by attempting to estimate "underreported capital flows," which it concedes might be due to both legitimate and illegitimate motives.<sup>369</sup> Capital flows can be short-term (typically up to a year) or long-term (more than a year).<sup>370</sup> (Simply noting an increase in claims recorded in one country and reduced in another tells us nothing about what type of claim is involved.). Income from portfolio investment—"the ownership of financial securities, broadly defined to include sales and purchases of securities and amounts of outstanding claims and liabilities reported by banks and nonbanking concerns"—and direct foreign investment

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366. *Id.* at 6.

367. *Id.* at 31.

368. *Id.* at 23 (emphasis in original).

369. *Id.*

370. BEENHAKKER, *supra* note 28, at 47.



are reported in countries' current accounts; "exchanges in financial assets" are reported in the capital account.<sup>371</sup> Inexplicably, *The Price of Offshore Revisited* fails to discuss or cite any of the rapidly growing literature on financial flows.<sup>372</sup> This may not be surprising since this literature raises issues that undermine TJN's focus on tax avoidance and instead demonstrate the impact of the quality of the legal environment in determining investment.<sup>373</sup> If investors have rational reasons for avoiding investing in particular countries, this undermines TJN's assumption that such investments would increase in the absence of OFCs. Instead, TJN assumes that "the most important factors driving" these flows are "long-term decapitalization" based on the observation that "net outflows from developing countries have continued over sustained periods of time."<sup>374</sup> This is a powerful assumption and not justified by the observation that firms and individuals have consistently shifted assets out of some jurisdictions and into others. It is at least plausible that such shifts might involve desires to move assets to jurisdictions with better quality legal institutions, more stable political environments, less corruption, and greater investment opportunities. TJN offers no evidence to support its rejection of more conventional explanations like these.

The method of examining residuals from official statistics might produce useful information. In theory, global current account balances should add up to zero, since money entering one country comes from another.<sup>375</sup> However,

[i]n practice there are large errors in measurement which mean that equality is not observed in the actual data. . . . If measurement techniques were perfect, and all the relevant economic transactions were traceable by the official statisticians, there would be no errors. It is important to realize, however, that these saving and current account surpluses, even perfectly

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371. *Id.* at 48.

372. In addition to works cited in this paper, see, e.g., IMF data and statistics on capital flows, <http://www.imf.org/external/data.htm>; Masahiro Kawai & Shinji Takagi, *A Survey of the Literature on Managing Capital Flows*, in *MANAGING CAPITAL FLOWS: THE SEARCH FOR A FRAMEWORK* (Masahiro Kawai & Mario B. Lamberte eds., 2012) and sources cited.

373. See, e.g., Papaioannou, *supra* note 302, at 7 (finding "a strong causal effect of legal system effectiveness indicators on the volume of cross-border lending activities.").

374. Henry, *supra* note 4, at 23.

375. BROWN, *supra* note 326, at 3.

measured, would be quite different for much of the time from the equilibrium concepts in which economists are interested.<sup>376</sup>

For example, the world current account balance has swung from negative \$14 billion in 1975 to a positive \$125 billion in 1990, then back down to \$50 billion in 1995, then up to \$174 billion in 2000, and back down to \$150 billion in 2005.<sup>377</sup> Within that time, the United States' current account balance swung between \$18 billion in 1995 to negative \$810 billion in 2005.<sup>378</sup> These dramatic movements in the total world current account balance as well as the U.S. current account balance suggest that there is some degree of noise in the system. More importantly, these differences suggest that there are substantial problems with measurement even in highly developed economies. Further, understanding these flows is made more complex because of the rapid pace of financial innovation, which complicates the valuation of securities and other financial instruments held by investors. Since the movement of money is merely the shifting of claims, as we explained above, not taking into account other forms of claims presents only a portion of the total picture.

Setting aside these complications, TJN estimates hidden funds by comparing the sum of sources of foreign capital ("foreign loans, net direct investment, and net portfolio investments") with "recorded uses" ("financing current account deficits and increasing official reserves").<sup>379</sup> The difference for each country is (by definition) "unrecorded net capital outflows."<sup>380</sup> As TJN notes, every item on its list is measured with error. TJN assumes, however, that "over time and across dozens of countries, the errors should more or less cancel out."<sup>381</sup> This is another powerful assumption and would be true only if the errors were randomly distributed around a zero mean. If measurement errors have a systematic bias to them, this would be an invalid assumption.<sup>382</sup>

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376. *Id.*

377. *Id.* at 4-5, Table 1.1.

378. *Id.*

379. Henry, *supra* note 4, at 28.

380. *Id.*

381. *Id.*

382. TJN claims to have "grudgingly" adjusted for fluctuations in exchange rates, although no details are provided. Since it also states that the adjustments made little difference, however, we can ignore the absence of information on what adjustments it made. *Id.* at 29 (it turns out not to make all that much difference to

There is no evidence that such a restrictive assumption on error distributions is correct—measurement errors in capital flows are not merely the result of random transcription errors in recording transactions, although such errors surely occur. They are also the result of systematic errors in recording due to accounting conventions, the wide range of decisions about how to value and report assets, and other features of international business, government, and accounting. Imposing a highly restrictive assumption about the distribution of errors on a model is an extremely powerful assumption that requires more than an assertion to justify it.<sup>383</sup> Without this assumption, however, TJN's estimates are worthless.

Next, TJN makes inappropriate assumptions about particular types of transactions. For example, TJN argues that round-tripping—where a country imports capital in one form and exports it in another form to and from the same other country—is a sign of bad behavior.<sup>384</sup> This is simply wrong. Round-tripping is “a pervasive feature of the global flow of funds.”<sup>385</sup> There are a variety of reasons for such flows. First, equity markets are more developed in some countries. For example, the United Kingdom and Switzerland have deep, well-developed equity markets. “Global investors buy shares in U.K. or Swiss companies which themselves make large direct investments in the world outside. In effect the U.K. or Switzerland become equity intermediation centers—some direct investment outside the U.K. or Switzerland that first passes through a British or Swiss multinational has ultimate equity owners also outside.”<sup>386</sup> The appearance of “global investment banks made

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the estimates” but “for the sake of academic purity” adjustments made).

383. See BENOIT MANDELBROT & RICHARD L. HUDSON, *THE MISBEHAVIOR OF MARKETS: A FRACTAL VIEW OF FINANCIAL TURBULENCE* (2007) (describing impact of mistakenly relying on a normal distribution of error terms).

384. The Tax Justice Network includes this among its dubious motives for unrecorded capital flows. While the paper suggests not to prejudge motives, round-tripping is described as “taking money offshore, dressing up in secrecy structures then pretending to be ‘foreign’ investors in order to take advantage of tax breaks only available to ‘foreigners.’” Henry, *supra* note 4, at 23.

385. BROWN, *supra* note 326, at 11.

386. *Id.* at 11. Round-tripping also occurs because managers in multinationals from some countries have a comparative advantage. For example, U.K. corporate managers have a comparative advantage “in undertaking and administering business in the English-speaking world (especially the US).” *Id.* at 12. Investors outside Britain and the United States may thus invest in British or American companies, which then buy assets in the investors’ home countries as a means of

it easy for the buying and selling of stocks to be directed to the best market, wherever that was."<sup>387</sup>

Similarly, even countries with a population that has a strong investor home bias produce round-tripping. For example, Japanese investors have a particularly strong home bias for Japanese equity investments, while foreign companies are reluctant to acquire Japanese equity investments because of market barriers and other factors such as the lack of a market for corporate control. On the other hand, Japanese firms are willing to acquire foreign assets. As a result, the in-flow of funds into Japan is matched over time by Japanese firms' outward investment, producing a round-trip for profits sent back to Japan.<sup>388</sup>

Third, some round-tripping is a result of discriminatory policies that oppress ethnic minorities, as with the circular flow of Malaysian Chinese or Indian citizens' funds out and back into Malaysia,<sup>389</sup> which cleanses their money of the ethnic quality that disadvantaged it under Malaysian law.

Finally, round-tripping may occur because firms and individuals anticipate changes in currency valuations. For example, considerable funds flow in and out of China as a result of anticipated appreciation of the renminbi (RMB), which leads Chinese firms to seek to borrow in foreign currency, interest by the Chinese diaspora in investment into China, and Chinese government purchases of dollar, euro, and other foreign currency-denominated assets.<sup>390</sup> Given all of these reasons for round-tripping, there is no basis to conclude that the existence of parallel flows of accounting claims between jurisdictions could only be evidence of illegal or even undesirable behavior.

Similarly, TJN claims that, "under-taxed corporate profits and royalties" are the source of funds "that have been parked offshore by way of rigged transfer pricing schemes."<sup>391</sup> Although it concedes that estimates of "transfer pricing abuses are more problematic" and so does not include them in its headline estimates, the report

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taking advantage of this management expertise.

387. Michie, *supra* note 293, at 59.

388. *Id.* at 13.

389. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 124.

390. BROWN, *supra* note 326, at 13-14.

391. Henry, *supra* note 4, at 24.

concludes "they are likely to be significant"<sup>392</sup> and so suggests their exclusion renders TJN's estimates a floor. TJN is selective in its consideration of transfer pricing issues, focusing on only examples that reinforce its position. As we described above, transfer pricing is an extraordinarily complex issue in which different firms operating in the same environment may have incentives to shift prices in opposite directions. In addition, TJN ignores the complications in relying on export figures introduced by Value Added Tax fraud, which can involve phony claims of exports.<sup>393</sup> The distinction is important since in a typical VAT fraud scheme the money would not actually move out of the jurisdiction but instead the party committing the fraud would claim a refund from the tax authority.<sup>394</sup> VAT frauds in developing countries would thus inflate recorded outflows (and so TJN's estimates) without any actual shift of resources out of a jurisdiction as the result of fraud within the country. Since this does not fit TJN's narrative, it is not mentioned.

Third, TJN makes a strong and implausible assumption about the destinations of the illicit funds. According to TJN, this money comes from the "myriad of illicit activities in the global underground economy—corruption, fraud, insider trading, drug trafficking, 'blood diamonds,' and innumerable other for-profit crimes" that provide "illicit loot" which needs concealment.<sup>395</sup> However, TJN assumes that the money from all of these activities ends up "idle in relatively-low-yield offshore investments," which leaves the "public sector . . . starved for capital (perhaps having to rely on high-cost loans or inflationary finance rather than tax revenue.)"<sup>396</sup> Offshore investments thus earn "a modest 6-month CD rate," which has been "'grossed down' to reflect the costs of offshore

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392. *Id.*

393. Michael Keen & Stephen Smith, *VAT Fraud and Evasion: What Do We Know, and What Can Be Done?* IMF Working Paper 10 (Feb. 2007), <http://www.imf.org/external/pubs/ft/wp/2007/wp0731.pdf> ("The universal zero-rating of exports means that fraudulent claims to have exported commodities are an intrinsic difficulty for the VAT.").

394. *Id.* at 9–10.

395. Henry, *supra* note 4, at 24. This is only a partial list—TJN asserts that "[t]here is a long laundry list of economic bads enabled by haven jurisdictions: not only tax evasion but also fraud, bribery, illegal gambling, money laundering, and traffic in contraband: drugs, sweatshops, human and sex trafficking, arms, toxic waste, conflict diamonds, endangered species, bootlegged software . . . the list is virtually endless." *Id.*

396. *Id.* at 25–26.

management.”<sup>397</sup> This is an implausible assumption in several respects. It assumes that people engaged in high risk criminal activities choose “low yield” investments for their money once they have spirited it out of the jurisdiction where their crimes are committed. Why criminals would choose to invest like cautious senior citizens is not explained and is unlikely considering the evidence of their appetite for risk from their choice of occupation. It is also counter to the usual assumptions about money laundering, which focus on the need to get the money into vehicles that permit using it.<sup>398</sup> Moreover, this ignores considerable evidence that the domestic cost of maintaining a corrupt regime is quite high.<sup>399</sup>

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397. *Id.* at 30. (It is unclear how much “grossing down” has been done, since no figures are provided.). We have attempted to find out where we can get a well-paying job managing wealthy people’s money by putting them in 6 month CDs from major banks but these jobs seem in short supply—in part because wealthy people seem to actually want their money managers to earn them money. *The Price of Offshore Revisited* refers to “our interviews with private bankers and other offshore industry experts” to determine that “the median private banking customer” is “much less interested in maximizing short-term returns than in securing an offshore nest egg—typically he or she is often taking quite enough risk, thank you, back home.” *Id.* This assumption is contradicted by one of *The Price of Offshore Revisited*’s key sources, the Merrill Lynch / Capgemini report, *World Wealth Report*. Merrill Lynch & Capgemini, *World Wealth Report 2011* (2012), available at <http://www.ml.com/media/114235.pdf>. That report found that “Many HNWI’s took on more risk in 2010 as markets continued to rebound from crisis-related losses. As a result, aggregate portfolio holdings shifted further toward equities and away from cash deposits and predictable fixed-income instruments.” *Id.* at 16. Among the many peculiarities of these assumptions is that a considerable amount of OFC business is on behalf of businesses and banks, which are looking for returns. For example, many banks offer overnight investment sweep accounts, in which excess funds are moved automatically to short term investment vehicles in offshore markets. See, e.g., BNY MELLON, *Investment Sweep*, <http://www.bnymellon.com/trea/suryservices/investmentsweep.html>; Sovereign Bank, *Automated Eurodollar Sweep*, <http://www.sovereignbank.com/institutional/investments/automated-eurodollar-sweep-institutional.asp>. Moreover, a serious critique of international finance over the past few decades is that it has been overly focused on achieving high returns, taking on too much risk at times. See, e.g., PHILIP AUGAR, CHASING ALPHA: HOW RECKLESS GROWTH AND UNCHECKED AMBITION RUINED THE CITY’S GOLDEN DECADE (2009) (describing flaws in UK’s financial services sector). TJN appears to be arguing that at just the time when everyone else in finance was busy chasing high returns on everything from overnight deposits to longer term investments in hedge funds, the tax evading class of criminals, money launders, and other undesirables was just looking for a nice quiet certificate of deposit with a low return.

398. P. Allen Schott, *COMPREHENSIVE GUIDE TO AML/CFT I-9* (2d ed. 2008).

399. See TONY HODGES, *ANGOLA: THE ANATOMY OF AN OIL STATE* 61 (2003) (“The bestowal of favors has been the favoured strategy for taming the civilian opposition

In addition, even if TJN's assumption of criminals buying low yield CDs from offshore banks is correct, this does not support TJN's conclusion that the money is idle. Once the money is transformed from the suitcase of cash into an accounting entry at the bank, the bank will invest the money itself (via loans, asset purchases, etc.) and so transform the money into productive capital. If the criminals are accepting low yields, the profits are accruing to the banks' shareholders and so are taxed as the banks' profits and/or through the shareholders when realized as dividends or capital gains.

Next, TJN bases its estimates on a claim about money in private banking institutions, where "First World private bankers employed by the top 50 or so institutions have orchestrated the systematic erosion of income and wealth bases in high- and low-income countries alike."<sup>400</sup> As "senior pilots in 'Capital Flight Air'" these bankers have allegedly helped clients "move a significant share—more than half, in the case of Latin America and some Asian countries—of their liquid capital to offshore accounts under the cover of shell companies and trusts, beyond the reach of domestic tax authorities."<sup>401</sup> It is hard to know how TJN can know the numerator (the fraction of Latin American and "some Asian" investors' assets), since the entire point of the OFC structures in TJN's framework is to conceal ownership of the assets, or the denominator (the total wealth of these investors). While there are some people hiding some assets somewhere, the estimate of "more than half" seems to be pulled from thin air.

TJN estimates that the top 50 global private banks (which are not listed in the report) held \$12.06 trillion in "private cross-border financial wealth" in December 2010.<sup>402</sup> This estimate is based on

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and limiting the 'risks' of democracy. . . . Oil wealth provides the presidency with enormous resources to buy off opponents and build alliances, while the lack or non-enforcement of transparent rules and procedures for the allocation of resources (whether diamond concessions, state contracts, privatization of state assets, land titles or business licenses) gives the head of state an array of mechanisms with which to dispense favours.").

400. Henry, *supra* note 4, at 31. Somewhat mysteriously, TJN asserts that these bankers have "assiduously recruited the world's wealthiest people as their clients, including tens of thousands of developing countries." *Id.* at 31-32. We're sure TJN meant "people from" rather than" of "but given *The Price of Offshore Revisited's* snide tone, we can't resist a jab."

401. *Id.* at 32.

402. *Id.* at 33.

unspecified and unreported calculations from “company annual reports and 10Ks, investment analysts, interviews with private banking industry experts, industry watchers like Wealth Briefing News and Money Laundering Alert, and a survey of recent market research studies for the private banking industry.”<sup>403</sup> Setting aside the complete lack of transparency in these “calculations,” the estimates are implausible when compared to larger economic trends. Counterintuitively, TJN’s estimate is that the amount of this wealth grew from \$5.4 trillion in 2005 to \$12.06 trillion in 2010—a remarkable performance during an unprecedented global financial crisis.<sup>404</sup> By comparison, consider that the advocacy group Better Markets (which we might expect to be aligned with TJN in general on policy questions) estimated that the financial crisis cost the U.S. economy at least \$12.8 trillion.<sup>405</sup> Mark Adelson, former chief credit officer at Standard and Poor’s (who we might not expect to be particularly ideologically sympathetic to TJN), estimated the cost of the financial crisis to the global economy at \$15 trillion.<sup>406</sup> The IMF estimated the cost of the crisis in 2009 at \$11.9 trillion.<sup>407</sup> For global private wealth invested in financial institutions to have more than doubled while those same institutions were undergoing an unprecedented crisis of liquidity and stability is truly remarkable performance—particularly if all that money was just in low yield CDs, as TJN hypothesizes.<sup>408</sup>

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403. *Id.* at 32.

404. *Id.* at 33.

405. See Dennis Kelleher et al., *The Cost of the Crisis* BETTER MARKETS 2 (2012), available at [http://www.bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis\\_2.pdf](http://www.bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_2.pdf).

406. Al Yoon, *Total Global Losses From Financial Crisis: \$15 Trillion*, REAL TIME ECONOMICS (Oct. 1, 2012, 5:52 PM), <http://blogs.wsj.com/economics/2012/10/01/total-global-losses-from-financial-crisis-15-trillion> (quoting Mark Adelson).

407. Edmond Conway, *IMF Puts Total Cost of Crisis at £7.1 Trillion*, THE TELEGRAPH (Aug. 8, 2009), available at <http://www.telegraph.co.uk/finance/newsbysector/banksandfinance/5995810/IMF-puts-total-cost-of-crisis-at-7.1trillion.html>.

408. The puzzle is presumably solved by the various government bailouts of large financial institutions. TJN does point to these bailouts as saving a number of “too big to fail” financial institutions, although it wonders why “Treasury Departments around the world” failed to realize “that these very same banks are leading the world in enabling tax dodging—indeed, to some extent, precisely because offshore investors know that they have been under-written by their Treasury Departments.” Henry, *supra* note 4, at 33, 34.



As a result of these powerful assumptions, largely unsupported by anything other than vague references to secret sources, TJN's estimates are unreliable. Because the case for Control First measures depends heavily on having a large estimate of the amount of potential revenue, not having a reliable estimate makes it more difficult to justify increasing financial transaction costs.

## 2. Corrections and Adjustments

A second category of problems with TJN's estimates is that the already problematic estimates are increased by additional corrections and adjustments. For example, TJN considers adjustments to principal and interest in arrears to be "fictional finance" rather than "actual cash flow;" since including it in the calculations produced "nonsensical results" (an undefined term but which appears to mean results that did not accord with TJN's desired outcome), it is excluded.<sup>409</sup> However, TJN counts debt forgiveness as a "use" of funds.<sup>410</sup> Thus if a debt grows because of missed interest payments, TJN does not count this increased liability but if a debt shrinks because of forgiveness, this is counted. TJN does not discuss how this factors into its claim that there is an accumulating stock of assets in OFCs. For example, if any of the assets TJN claims exist outside the recorded economy are invested in bonds issued by a developing country and held in an offshore account, those investments will lose value when a portion of the debt is cancelled.<sup>411</sup> Since TJN simply sums its estimates of flows out each year, failing to adjust for this leaves an overstatement of the stock it estimates exists offshore.

Similarly, TJN finds that following its methodology for China would yield an "implausible" estimate of Chinese foreign investment (13 percent).<sup>412</sup> TJN suggests "much of [China's] unrecorded capital transactions with Hong Kong are probably

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409. *Id.* at 28.

410. *Id.* at 29.

411. This seems likely. For example, hedge funds hold considerable Argentine public debt and have been engaged in extended legal battles with the Argentine government over the terms of repayment. See Roben Farzad, *Argentina's 11-Year War with Hedge Funds*, BLOOMBERG BUSINESSWEEK (Nov. 29, 2012) <http://www.businessweek.com/articles/2012-11-29/argentinas-11-year-war-with-hedge-funds>. Since these are the sorts of funds TJN finds objectionable, they are likely to have investors TJN objects to as well.

412. Henry, *supra* note 4, at 31.

double-counted. A significant amount of China's apparent capital flight is actually just 'round-tripping' by way of intermediary companies based in Hong Kong and a few other key havens, notably the British Virgin Islands."<sup>413</sup> TJN also argues there is considerable trade mis-invoicing through Hong Kong.<sup>414</sup> Without providing evidence that these claims are true, TJN has adjusted the results of their calculations to get ones more to their liking instead of abandoning a method of estimation that yielded "implausible" results.<sup>415</sup>

It is worth unpacking this example because it is revealing of the flaws in TJN's methodology. There is not a single source cited in the discussion of "China's Story," although numerous factual claims are made. According to TJN, Hong Kong is a major center facilitating both trade mis-invoicing and flight capital from China.<sup>416</sup> Yet Hong Kong is part of the People's Republic of China and the national Chinese government has both de jure and de facto authority over it. (Indeed, if there is concern within Hong Kong over the territory's relationship with China, it is that China exerts too much control, not too little.) If Hong Kong was undermining the Chinese tax system and denying the Chinese national government access to tax revenue it needed to provide public services on the scale TJN alleges (US\$125.9 billion from Hong Kong according to TJN's estimates), surely the Chinese government would have noticed this and taken steps to halt the practice. After all, Hong Kong has only limited autonomy under its Basic Law and the Chinese Constitution—the "one country, two systems" framework—and certainly does not have the level of legal autonomy that even British Overseas Territories or Crown Dependencies possess with respect to the United Kingdom.<sup>417</sup> In short, there may be "two systems," but China is certainly "one country" with respect to enforcement of Chinese

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413. *Id.*

414. *Id.* Henry suggests that many of China's unrecorded capital outflows with respect to Hong Kong are double counted.

415. *Id.* (Hong Kong capital outflows estimate "permits us to adjust China's accumulated wealth estimates accordingly.").

416. *Id.* at 38.

417. See Ray Yep, *Understanding the Autonomy of Hong Kong From Historical and Comparative Perspectives*, 24 CHINA INFO. 235, 236 (2010) ("While the Basic Law prescribes the parameters for engagement between the central people's government and the HKSAR government and the jurisdictional boundary of the latter, the flexibility of these limits is subject to decision by the former through its power to make, unmake, and interpret the Basic Law.").

law. This leaves TJN in a difficult position: either Hong Kong is not an illegitimate tax haven or the Chinese government is somehow allowing massive wealth to escape through Hong Kong. For TJN to complete this argument, it must argue that the Chinese government is both corrupt (and so interested in allowing the looting to occur) and incapable of moving money out of China without a costly and elaborate charade involving Hong Kong's financial system. No doubt there is corruption in China, as there is virtually everywhere. But the idea that Hong Kong is needed to facilitate corruption on the mainland is ludicrous. By making an ad hoc "adjustment" to the inconvenient results of their model in the case of China, TJN reveals the problematic nature of their calculations.

Hong Kong intermediates a great deal of China's external trade and serves as a key vehicle for international investment into China.<sup>418</sup> This provides a better explanation for the flows of claims through Hong Kong. What TJN ignores is that Hong Kong is a multinational financial services center and entrepôt, which provides sophisticated business and financial services to companies as well as a legal system recognized as sophisticated on business issues.<sup>419</sup> The Hong Kong Stock Exchange is a deep and sophisticated capital market using a convertible currency (the Hong Kong dollar) that allows access to Chinese investments for investors who cannot invest through mainland stock exchanges because of China's restrictions on RMB convertibility. Major Chinese businesses, including ones with substantial state ownership stakes, have listed on both the Hong Kong and Shanghai stock exchanges.<sup>420</sup> There is little doubt that some Chinese investors seek to obtain the benefits of Hong Kong's legal and business environment as well as tax and

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418. Yue-Chim Richard Wong, *The Role of Hong Kong in China's Economic Development* (Univ. of H.K., Int'l Ctr. for the Study of E. Asian Dev., Kitakyushu, Working Paper Series Vol. 2002-06, Nov. 2002), available at [http://file.icsead.or.jp/user03/927\\_186.pdf](http://file.icsead.or.jp/user03/927_186.pdf).

419. See, e.g., *Report on the First Five Years*, *supra* note 40, at 33 ("The rule of law is one of Hong Kong's greatest strengths. It is the cornerstone of Hong Kong's success as a leading international commercial and financial center, providing a secure environment for individuals and organizations and a level playing field for business.").

420. See Clark Liu & Mark S. Seasholes, *Dual-Listed Shares and Trading* (Working Paper, Dec. 2011), available at [http://www.cfainstitute.org/learning/products/publications/contributed/equityinvestments/Documents/rf\\_dual-listed-shares-and-trading.pdf](http://www.cfainstitute.org/learning/products/publications/contributed/equityinvestments/Documents/rf_dual-listed-shares-and-trading.pdf) (examining dual listed companies and finding price impacts of differences in share rights).

other advantages China offers to “foreign” investment by routing investment funds through OFCs like the BVI.<sup>421</sup> Indeed, since such activity is openly discussed in financial circles, it is certainly well known to Chinese authorities.<sup>422</sup> China might tolerate such investments to gain the benefit of “genuine” foreign investment or because it believes offering its own investors the benefits of Hong Kong’s legal and financial systems are worth the cost in foregone tax revenues. By operating in a factual vacuum and ignoring the role that financial centers like Hong Kong play in the world economy, TJN grossly oversimplifies the functioning of world economy, which undercuts the credibility of its estimates.

Having created estimates of money flows, TJN augments its numbers using estimates of “how much these accumulated flows might be worth over time.”<sup>423</sup> This is a particularly vigorous shifting of the cards in the three card monte game, since TJN simply “assumes that a significant portion—50 to 75 percent, on average—of these tax-free earnings are not repatriated to source countries but are reinvested abroad in relatively ‘safe’, low-yielding investments, denominated in traditional reserve currencies like US dollars.”<sup>424</sup> TJN supports this assumption with the “fact” that “most haven investments are made for longer-term motives like asset protection, money laundering, and diversification, not just short-term speculation, with low turnover and high reinvestment rates.”<sup>425</sup> Not

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421. The success of the BVI in providing companies to intermediate Hong Kong/China investment stems from the pre-Hong Kong handover period, when many Hong Kong residents were concerned that the Chinese Communist government might expropriate their property. In 1989, representatives of the BVI Government travelled to Hong Kong to advertise the ease of setting up BVI companies and the security of ownership under BVI/British law in Hong Kong prior to the turnover. As a result, many Hong Kong residents transferred property ownership to BVI companies. IMF, I ASSESSMENT OF THE SUPERVISION AND REGULATION OF THE FINANCIAL SECTOR, THE BRITISH VIRGIN ISLANDS 16 (2003), available at <http://www.imf.org/external/pubs/ft/scr/2004/cr0492.pdf>.

422. See Geng Xiao, *People's Republic of China's Round-Tripping FDI: Scale, Causes and Implications* (Latin America/Caribbean and Asia/Pacific Econ. & Bus. Ass'n, Working Paper 24, Dec. 2004), available at [http://www5.iadb.org/laeba/downloads/WP\\_24\\_2004.pdf](http://www5.iadb.org/laeba/downloads/WP_24_2004.pdf) (estimating average round-tripping FDI is between 20%-30% of Chinese capital flight, and suggesting that profit-motive and risk diversification for developing countries determine the level of round-tripping FDI).

423. Henry, *supra* note 4, at 29.

424. *Id.* at 29–30.

425. *Id.* at 30. This adjustment is peculiar in that “diversification” and “money laundering” are dramatically different activities, which cannot be categorized as similar.

only are criminals bad investors, but they are also world-class savers! This is staggeringly implausible.

Finally, TJN uses what it labels as "The Offshore Investor Portfolio Model" based on Bank of International Settlements (BIS) data on cross-border deposits, wealth management industry analysts' assumptions about portfolios, and "interviews with actual private banks."<sup>426</sup> TJN begins with multiplying the amount of offshore deposit liabilities by non-banks (using figures from the BIS) by three, which TJN says is a "super-conservative" choice to account for high net worth individuals' portfolios' allocation of assets into offshore "'security blankets' for more risk-averse investors."<sup>427</sup> Multiplying things by three certainly makes numbers bigger, which appears to be TJN's goal in such an arbitrary calculation. Finally, TJN assumes that illiquid investments in hedge funds, art, real estate, and private equity make up 10-17 percent of these individuals' portfolios. Thus for every dollar of nonbank deposit liabilities in an offshore bank, TJN would add to its estimate of offshore financial wealth two more dollars, turning the \$7.01 trillion into its lower estimate of \$21 trillion. TJN also hints that more should be added to reflect the likelihood that its 3.0 multiplier is too low and to account for the illiquid assets.<sup>428</sup>

There are many problems with this "multiply things by a number we made up" method of "estimation." First, it assumes that all of the nonbank deposit liabilities in offshore banks are deposited there by high net worth individuals. This is false. Many deposits in banks in offshore jurisdictions made as part of Eurocurrency market lending by institutions and are derived from sweeps of overnight deposits.<sup>429</sup> TJN's first error in this regard is to assume that all OFCs resemble Switzerland, which has an active private banking business

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426. *Id.* at 34. We would have thought talking to private bankers would have been more productive than discussing things with the banks.

427. *Id.* at 35.

428. We're not sure why the illiquid assets are broken out separately since the liquidity ratio would presumably reflect them already, but TJN does not explain the role of this adjustment. *Id.*

429. See Paul S. Pilecki, *It Pays to Reduce Free Balances When Interest Rates Are Rising*, CMTY. BANKER 2 (Dec. 2005), available at <http://winstonandstrawn.com/siteFiles/publications/websiteversion.pdf> (describing how "Larger organizations also use Cayman or Nassau branch deposits or commercial paper issued by a holding company affiliate as the investment vehicle in a sweep arrangement. If a bank has an offshore branch, a sweep can be operated without significant operational difficulties....").

in which much (but not all) of banks' assets represent deposits from high net worth individuals. OFCs are a diverse set of jurisdictions, with many not pursuing individual clients in banking but focusing on other markets. Evidence that TJN's approach is flawed can be seen in the drop in high net worth individual's cash/deposits holdings between 2010 and 2011 from 17 percent to 14 percent, a drop that is not reflected in any adjustment in TJN's estimates.<sup>430</sup>

TJN's second error in constructing this estimate is to assume that an investor's overall portfolio is mirrored in the offshore portion of his or her portfolio. Thus even if TJN is correct that a customer of a Swiss private bank keeps his or her liquid assets in the Swiss account, there is no evidence to support the assumption that the less liquid assets are also kept in Switzerland. Moreover, it is unclear what it means for a Rembrandt painting to be "in" Switzerland, unless it is physically present in Switzerland, although its owner is elsewhere. As with other adjustments, TJN claims to have "checked" its liquidity ratio calculations "with private bankers and industry sources" for confirmation, but none of these people are identified and no sources are cited.<sup>431</sup>

TJN's third error is to lump all high net worth individuals together. To take just one obvious source of differences, the Merrill Lynch/Cap Gemini *World Wealth Report*, on which TJN heavily relies, finds that individuals from different countries have different preferences for the percentage of their assets held in liquid form. For example, wealthy Japanese tend to hold "55% of their aggregate portfolio in fixed-income and cash/deposit vehicles at the end of 2010, up from 48 percent a year earlier and above the global average of 43 percent."<sup>432</sup>

A fourth problem is that the *World Wealth Report* suggests that TJN's assumptions about the looting of developing countries are incorrect. According to that report, 53 percent of total worldwide high net worth individuals live in the United States, Japan, and Germany. Nine of the top 10 nations for numbers of high net worth

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430. *World Wealth Report*, *supra* note 397, at 16. TJN might respond that since they are assuming a lower ratio, this does not matter. That is incorrect as what matters is the change in flow. Thus even if their point estimate is lower than Merrill Lynch/Capgemini's, if they argue that wealth reports like Merrill's are valid they need to accept that it can indicate a reduced percentage of cash holdings whatever their assumptions about the point estimates.

431. Henry, *supra* note 4, at 36.

432. *World Wealth Report*, *supra* note 397, at 16.

individuals in 2010 are developed economies; the only exception is China.<sup>433</sup> (Brazil and India rank 11th and 12th.). The United States alone has over 40 percent of all high net worth individuals; China has 6.4 percent. The developed economies have 89.9%; the three largest developing economies, just 10.1%. This suggests that TJN has vastly overstated the number of looters in developing countries who have managed to hold on to their ill-gotten gains.

The common theme among these adjustments and corrections is that TJN has manipulated its assumptions to consistently increase the size of the estimate, while discarding any model predictions that would be seen as implausible or which detract from its preferred narrative. Its estimates should therefore be ignored in serious policy debates.

### III. Coping with Uncertainty and Policy Choices

How much money is “moving” around the world in criminal transactions? How many people and firms are illegally evading taxes? No one knows. TJN’s eye-catching estimate of massive hidden wealth languishing in low yield CDs in offshore jurisdictions is largely the product of the assumptions made rather than a reasonable approximation of a concededly difficult number to estimate. Unfortunately, because it is a huge number, it has attracted widespread attention—particularly from governments weary of austerity measures looking for easy fixes.<sup>434</sup> In light of the uncertainty about the relative size of beneficial international and harmful financial transactions, rational policy discussions are difficult. How then to have a reasonable discussion of the costs and benefits of the various policy proposals made by Control First advocates? We suggest four important issues.

First, policymakers need to be clear about whether they are approaching financial issues from an Efficient Enterprises or a Control First framework; is the goal to facilitate creating wealth or prevent bad behavior? If a Control First approach is going to be taken, are there any limits to it? Are the constraints that capital markets impose legitimate or illegitimate? Do all governments and their policies get presumptions of legitimacy? For example, can a country confiscate one ethnic group’s wealth with impunity, as

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433. *World Wealth Report*, *supra* note 397, at 7, Figure 3.

434. *See supra* note 347.

Zimbabwe did to white farmers, or redistribute wealth more generally, if less dramatically, from one ethnic group to another, as Malaysia has done? Can a government involuntarily swap its citizens' holdings in non-local currencies and for national currency, as Argentina did, or print as many units of currency as it wishes, as Venezuela is currently doing without suffering financial consequences? May a government criminalize reporting economic information, as Argentina has,<sup>435</sup> and still be treated as a trustworthy regulator of financial transactions? What about democracies where tax policy is set based on a "mass feeding frenzy" that produces a "swamp of unfairness, complexity, and inefficiency" (Steinmo's description of the U.S. tax system as it developed after World War II) or "dramatic see-sawing of tax policy and the fiscal incoherence these changes have wrought" (his description of post-War British tax policy)?<sup>436</sup>

Second, what are the constraints imposed by the need for the rule of law on Control First measures? Is tax avoidance—that is, following the rules to reduce one's tax burden—legitimate? If not, how are tax obligations determined? Are they determined by individual negotiation with tax authorities?

Third, what criteria will be used to judge the effectiveness of those Control First measures that are adopted? Are there specific revenue targets that must be reached? Is there a yardstick by which to determine if there are measures that are too expensive?

Finally, who pays for the costs of the Control First measures? Are all governments responsible for the costs within their jurisdiction? Are private actors responsible for the costs they incur? Are there limits to these costs? Who decides which measures are required? Do all jurisdictions have a voice in determining which measures are adopted?

To conclude, we turn to applying the frameworks to the policy issues facing governments with respect to the degree to which they will choose to facilitate or obstruct the movement of money across borders. We examine three key issues where the differences in approach between these two frameworks are critical to the policy

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435. *The Price of Cooking the Books*, *ECONOMIST* (Feb. 25, 2012) <http://www.economist.com/node/21548229> (noting that "The [Argentine] government has gone to extraordinary lengths, involving fines and threats of prosecution, to try to stop independent economists from publishing accurate inflation numbers.").

436. STEINMO, *supra* note 23, at 163, 165, 206.



choices: international investment, taxation, and financing governments.

### *A. International Investing*

Investments are not equally easy in all jurisdictions. Investors must cope with country risks when investing across borders, and not all countries present the same risk profiles.<sup>437</sup> In addition, there are other asymmetric obstacles to cross-border lending. Developing markets may present "cultural differences and lack of information" and "differing accounting and disclosure practices,"<sup>438</sup> while well-developed capital markets such as the United States, E.U., or Japan offer well-understood practices that are easily accessible even to outside investors. Where legal systems are not as developed, investors face additional risks. Such risks include "(a) the rudimentary protection of intellectual property rights (patents, trademarks, copyrights), (b) the inadequate regulation of fair trading and competition, (c) problematic dispute regulation (unequal access to courts, unenforceable foreign judgments, and the inability to refer disputes to arbitration) and (d) limited rights to appeal."<sup>439</sup> Many developing countries also seek to encourage foreign investment by offering incentives including tax incentives.<sup>440</sup>

Access to well-functioning, liquid capital markets is an important means of reducing financing costs. Many countries do not have such markets, as a result of a variety of factors including: information barriers, particularly with respect to accounting standards and disclosure; transactions costs, including taxes on transactions and high fees for transactions; foreign exchange risk; regulatory barriers, including relatively high levels of capital gains taxation; lack of liquidity; and political risk, including concerns over government interventions, lack of capital market laws and institutions, and poor quality judicial institutions.<sup>441</sup>

Where countries have tried to control capital movements, they

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437. BEENHAKKER, *supra* note 30, at 51 (explaining country risk as "the possibility that unexpected events within a host country will influence a client firm's or a government's ability to repay a loan.").

438. *Id.*

439. *Id.* at 56.

440. Mo, *supra* note 188, at 133.

441. BEENHAKKER, *supra* note 30, at 173.

have often created unintended bad consequences. Brazil's efforts to control capital flight, which dated from 1962 to 1990, restricted capital remittances by taxing remittances above 12 percent heavily. When inflation created a black market for foreign currency, foreign firms found it worthwhile to repatriate funds above 12 percent at the official exchange rate, pay the tax, and then reinvest via the black market rate, more than offsetting the tax liability.<sup>442</sup>

The fundamental question is whether cross-border investment is presumptively beneficial or presumptively harmful. If the former, then the policy goal should be to minimize the transactions costs of such investments, imposing burdens only when the cost can be justified as preventing a harmful activity (e.g., money laundering). This requires demonstrating that the effort actually accomplishes its goal.

### ***B. Collecting Taxes***

Collecting taxes is not a simple task. Indeed, a recent survey of tax issues concluded both that "[c]omplexity is the unavoidable rule of corporate income tax structures"<sup>443</sup> and that tax administration "is typically . . . the most difficult to get right."<sup>444</sup> Many developing countries lack the government infrastructure to administer a complex tax system (such as the U.S. tax system). It is not even clear that the United States has the capacity to administer its enormously complex tax system. Among the problems contributing to tax administration difficulties are: lack of rule of law and transparency, including rapid changes and instability in tax laws; lack of a tradition of voluntary compliance with tax laws; lack of efficiency in administering tax laws, including lack of capacity to perform audits, nonexistent third party information, and too few trained personnel; corruption, which allows poorly paid civil servants and poorly drafted, overly simplistic tax laws to become the source of bribes; frequent tax holidays used to attract foreign investment, encouraging businesses to report losses until a holiday occurs; competition for investment, which limits aggressive enforcement of tax laws.<sup>445</sup>

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442. STOPFORD, STRANGE & HENLEY, *supra* note 11, at 105.

443. Emilio Albi & Jorge Martinez-Vazquez, *Introduction*, in ELGAR GUIDE, *supra* note 7, at 1, 4.

444. *Id.* at 7.

445. *Mo*, *supra* note 188, at 12–13. *Mo* describes the impact on tax collections of

When particular incentives are available, businesses and individuals structure transactions to take advantage of these incentives. For example, China offered a lower tax rate for firms receiving foreign financing at less than LIBOR plus 0.25 percent. At a time when LIBOR was 10 percent, a firm borrowing RMB10 million from a Japanese lender re-characterized its initial loan rate of 10.4 percent to be 10.2 percent plus a service fee of RMB200,000 and so qualified for the preferential tax rate.<sup>446</sup> China could have written its tax laws to require calculation of an effective interest rate including such fees, but it did not. Was the transaction illegitimate? One response is to argue that tax authorities should be able to exercise discretion to disallow tax strategies administratively when they determine they are inconsistent with the intent of the tax laws. Alternatively, countries that create tax laws that offer such incentives could adjust their own tax laws to ensure that only transactions they seek to incentivize are able to take advantage of the provisions. We think the latter should be required before a jurisdiction asks other jurisdictions to alter their laws or restructure the entire financial system.

Moreover, jurisdictions need to take responsibility for their own policy choices and implementations. In many instances, poor quality tax policy can complicate tax administration and contribute to avoidance and evasion. For example, Mo describes Mexico's tax evasion problems as the result of the combination of complex tax laws, "dysfunctional preference schemes," a large informal sector, inflation, and inefficient tax administration. Several aspects of the Mexican system sound much like what TJN and other Control First proponents advocate:

Specifically, tax laws have been structured in which taxpayers are treated as potential tax dodgers. Therefore they have to comply with a huge number of formal requirements and different obligations. The requirements that taxpayers have to fulfill to

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the competition among local authorities in China for investment as producing "a flexible approach toward enforcing the [tax] law whereas statutes and regulations can be interpreted broadly to suit the need of other public policies. There are inconsistencies among local, provincial, and national laws and regulations. . . . For instance, receipts from enterprise income tax are shared between local and central government, while individual income tax revenue is destined only for local governments. Being dependent on revenue, individual local governments have more incentives to grant tax reductions to promote local businesses and attract foreign investment, thus creating inconsistencies." *Id.* at 79-80.

446. *Id.* at 80-81.

take certain deductions are overcomplicated and formal.

In the past, legislation has repeatedly been based on exemptions, which has led to great complexity throughout the tax system. In many cases, the inspection efforts of tax authorities have been transferred to the taxpayers, who have to cover the resulting administrative costs. Every effort has been made to give the tax authorities every facility to perform official inspections, which complicates the entire tax system.<sup>447</sup>

This approach creates its own corruption and tax leakage problems.

The preferential treatments of taxpayers create significant loopholes. For example, the simplified tax regime allows small companies with less than \$300,000 annual sales to pay income tax at a flat rate with a ceiling of 2.5% of income earned, less an amount equal to three times minimum wages. This system that taxes the difference between income and outlays on a cash-flow basis, not only makes inspection difficult, but also treats among other income tax payers unequally. In addition, large corporations can take advantage of this loophole by splitting into a number of small companies that are less scrutinized in underreporting earnings. Lack of administrative capacity at the provincial level is also a major impediment for progress.<sup>448</sup>

More generally, Mo concluded from her study of four major developing economies that, "an ineffective tax administration system is a key factor leading to a high level of noncompliance."<sup>449</sup> Mo is generally unsympathetic to tax avoidance measures, and we find her description fits the Control First approach to taxes closely. Yet, her proposed solution was the opposite of the Control First approach: simplification of tax structures as an important means for improving tax compliance.

A simplified tax structure will enable tax authorities to shift their attention from monitoring of eligibility for exemptions and special treatment give to firms and individuals, to more productive activities such as development of a master file of taxpayers, collections, and audits. In addition, it is easier for taxpayers to understand, and therefore comply with simplified uniform rules. With fewer special rules, there are also fewer opportunities to avoid or evade by mis-classifying income, overstating deductions, and claiming exemptions or credits. Finally, a simplified tax

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447. *Id.* at 123–24.

448. *Id.*

449. *Id.* at 166–67.

structure would reduce the scope for corruption since complexities and ambiguities in tax law facilitate many taxpayers to evade taxes.<sup>450</sup>

This is consistent with an Efficient Enterprises framework: simplifying and improving domestic tax law's administration and content facilitates more transactions, which yields more wealth.

The same point is seen in the discussion of transfer pricing. As noted earlier, many Control First proponents argue that transfer pricing is a key method of illegitimate shifting of money from higher tax jurisdictions to lower taxes.<sup>451</sup> However, this assumption is not accurate. For example, a survey found that much of the writing on transfer pricing was about tax issues, while managers had a much broader set of concerns.<sup>452</sup> The allocation of earnings across a firm's operations is rarely a simple task and the models used by tax authorities to do so based on methodologies "founded on basic assumptions about market structure and firm behavior that are rarely empirically valid."<sup>453</sup> As a result of these methodological problems, "multinational firms are unable to accurately anticipate their tax liabilities in individual countries."<sup>454</sup>

The Control First approach to taxation is thus based on an unrealistic assumption that any tax system a government (or NGO) can imagine can be implemented. However, there are myriad constraints on governments imposed by the world. Tax competition provides one set, but taxes are just one of many criteria used by firms and individuals in making financial plans.<sup>455</sup> Moreover, the

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450. *Id.* at 169.

451. For example, Picciotto argues that multinational firms have a competitive advantage in their ability to "use a network of often fictional subsidiaries to exploit all the possibilities of the interaction of tax systems, as well as the growing tax treaty network." Picciotto, *supra* note 7, at 52-53. He describes this advantage as: this entails a system of intermediary 'stepping stone' subsidiaries, which are used to channel the transfer of assets and returns on investment to and from foreign operating subsidiaries, through conduit companies (formed in a treaty country) and then on to holding companies in low-tax havens.

Picciotto, *supra* note 7, at 53.

452. SHULMAN, *supra* note 312, at 3.

453. KING, *supra* note 235, at 1.

454. *Id.*

455. Albi, *supra* note 7, at 139 (a multinational may decide to establish itself in a country, in spite of taxes, to serve its consumers better or because of product transport costs. Other important factors in the location decision of foreign direct investment (FDI) are relatively low wages or a qualified workforce. Quality of

requirement of the rule of law that tax (and other) laws be written down in advance inevitably leaves opportunities for tax avoidance through structuring. In many instances, avoidance efforts take advantage not of “loopholes” but tax code provisions put in place deliberately to serve policy objectives (e.g., to promote investment), satisfy political preferences (e.g., a preference for indirect taxation), or special interests (e.g., tax credits for favored industries). To single out a single piece of a multi-dimensional policy, as the Control First approach does, is doomed to fail. What most of the Control First proponents fail to recognize is that governments face a series of tradeoffs in designing tax and other policies. In particular, tax policy is not simply a matter of announcing a rate and collecting the revenue.<sup>456</sup> Different methods of taxation are susceptible to different methods of avoidance and evasion.<sup>457</sup>

Moreover, an important component of cross-border financial flows is external financing of government spending. For example, the large U.S. budget deficits in the 1980s combined with relatively high U.S. interest rates and the perceived safety of U.S. government debt led to large capital inflows into the United States.<sup>458</sup> Similarly, the relative safety of U.S. government debt and today’s even larger deficits is drawing capital into U.S. financial markets despite low

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infrastructure or the management skills of the country’s business community, with good goods and services providers, are also important for FDI location.”).

456. Consider Norway, sometimes touted as a model of relatively progressive tax rates by “tax justice” advocates. If one goes beyond the rates, one discovers that Norway “has a petroleum tax system with such generous depreciation allowances that, when added to interest payment deductibility, normal returns on investment in this sector are practically tax exempt.” Albi, *supra* note 7, at 134.

457. For example, income taxes can be evaded by illegally failing to report income to tax authorities. An American citizen who earns income in Britain could thus evade American income taxes by not informing the Internal Revenue Service of the British income and not paying the tax owed under the U.S. system of worldwide income taxation. A British citizen who was not resident in the United States would not be engaged in tax evasion for failing to report income earned in the United States, however, because under the British system of territorial taxation, British taxpayers owe income taxes only on income earned in Great Britain. Income taxes can be legally avoided by structuring a source of income so that the income is not taxable by a particular tax authority. Locating an asset in a low tax jurisdiction or a jurisdiction that does not tax a particular form of income thus reduces the tax burden. For example, a non-American taxpayer who deposits money in an interest-bearing account in the United States is not liable to the United States for income tax on the interest. If his home jurisdiction does not tax foreign source income, he would avoid tax on the interest income by depositing the funds in a U.S. bank rather than a home jurisdiction bank.

458. BEENHAKKER, *supra* note 30, at 50.

returns, since returns globally are depressed by central banks' easy money policies.<sup>459</sup> Focusing only on the tax portion and ignoring the borrowing portion is dangerously incomplete.

#### IV. Conclusion

As we have shown, the global financial network is a complex system that uses different jurisdictions for different purposes. Some of these purposes are legitimate, while some are not. The question facing policy makers around the world is how much reworking the system can tolerate before the benefits it yields are too eroded. Unfortunately, that debate turns in part on data that is impossible to obtain. The most recent effort by the Tax Justice Network falls so far short of any reasonable analysis that it cannot be considered seriously.

As a result, the debate is being conducted based on world-views rather than realistic cost-benefit appraisals. Certainly, as Richard Bird argues, "tax researchers need to understand the real constraints and objectives facing [developing country] policy makers before offering them pre-cut solutions to what researchers think are their problems."<sup>460</sup> Control First proponents believe that the most important thing is to stop bad things happening in finance. By contrast, Efficient Enterprises proponents, like the two of us, believe that the analysis should begin with the promotion of economic growth. We think the debate needs to begin with discussion of those priorities rather than masked by the pretense of data. In conducting that debate, it is vital that competing policy proposals consider the benefits as well as the costs of jurisdictional competition. *The rule of law is all too scarce in today's world and jurisdictions that specialize in providing it to others provide a valuable service that needs to be recognized.*

The overly simplistic, conspiracy-theory view of international finance promoted by the Tax Justice Network must give way to a realistic appraisal of the tradeoffs imposed by real world conditions before the international tax competition debate can find solutions to the difficult problems created by differences in national tax regimes. As Richard Bird convincingly argues,

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459. See Martin S. Feldstein, *The Budget Deficit and the Dollar*, 1 NBER MACROECONOMICS ANNUAL 355, 356-358 (Stanley Fischer ed., 1986) (discussing causes of capital inflows into the United States in early 1980s).

460. Bird, *supra* note 24, at 428.

The level and structure of taxation reflect deep-seated institutional factors that, in the absence of severe shocks, do not change quickly. Tax policy decisions are not made by a benevolent government. Taxation is not just a means of financing government; it is also a very visible component of the social contract underlying the state. Citizens are more likely to comply with tax laws if they accept the state as legitimate and credible and are thus to some extent both willing to support it and afraid of what will happen to them if they don't. [A]ny major tax reform is thus always and everywhere an 'exercise in political legitimation'. Those who will have to pay more must be convinced that they will get something worthwhile for their money. Those who do not want to pay more must not be able to block reform and, in the end, must be willing to go along without taking to the hills in revolt or fleeing the country. Those within the government and in the private sector who have to implement the reform must support it or at least not actively sabotage it. And of course politicians have to see sufficient support to warrant putting reform not only on the agenda but on the ground.<sup>461</sup>

This suggests that the solution to tax evasion lies in substantial part in reforming governments to ensure that they uphold their side of the social contract.

In addition, there are trade-offs to be made on virtually every margin in the design of tax systems and ignoring them is a recipe for dysfunction. Improving international tax systems is more likely to result from continuing "to eliminate tax preferences," "a better approximation of tax depreciation to the actual depreciation of assets," and continuing "the process of base-broadening and rate-moderating that started in the second half of the 1980s."<sup>462</sup> However, these steps are much less likely to grab headlines than over-hyped, fanciful claims of trillions of hidden wealth and require boring discussions of technical details rather than rhetorical flourishes such as denunciations of "pirate bankers."

As Albi notes, "[g]ood tax administration performance is a must for all taxes."<sup>463</sup> Providing tax officials and policymakers with the information needed to tackle the messy job of real tax reforms in developing countries is thus key.<sup>464</sup> Devoting more resources to

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461. Bird, *supra* note 24, at 428.

462. Albi, *supra* note 7, at 162.

463. *Id.* at 163.

464. *Id.* at 169.



creating honest, competent governments in jurisdictions where corruption and incompetence is the norm is critical<sup>465</sup>—and not addressed by denunciations of jurisdictions providing rule of law services to the rest of the world. Moreover, reality may constrain the choice of tax structures in ways that do not accord with individuals' or NGOs' preferences. For example, as Martinez-Vazquez and Bird argue, "even a bad VAT is often likely to be better than the possible alternatives in even the poorest countries,"<sup>466</sup> shifting from income taxes to consumption taxes may be preferable to TJN's desire for redistribution when other factors are weighed in with such preferences.<sup>467</sup>

Finally, there are real issues of respect for sovereignty that must be addressed, and which the Control First view ignores. Today's international financial institution regulation "is dominated by a few rich or large countries."<sup>468</sup> If we live in a world where international relations require respect for the sovereignty of *all* jurisdictions, the shifting of costs from large, wealthy jurisdictions to small ones demanded by the Control First proponents is illegitimate.

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465. Bird, *supra* note 24, at 416–17 ("[Lord] Kaldor ... was thus right in the important sense that countries that wish to tax more need to ensure their governing institutions facilitate the achievement of this goal. Doing so by such oft-suggested means as enhancing the rule of law, reducing corruption and the shadow economy, and improving tax morale, is neither simple nor easy.").

466. Jorge Martinez-Vasquez & Bird, *supra* note 248, at 231.

467. Another example is Alexander et al.'s call to allow developing nations to substitute "macroeconomic controls for the resource intensive firm-level regulation" required today for financial institutions. ALEXANDER ET AL., *supra* note 2, at 269. This would be inconsistent with the type of individual transaction controls proposed by TJN and other Control First groups.

468. *Id.* at 171.